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# Structuring Cross-Border Lending Transactions: Mitigating Legal, Economic and Political Risks

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# STRUCTURING CROSS-BORDER LENDING TRANSACTIONS:

## MITIGATING LEGAL, ECONOMIC AND POLITICAL RISKS

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March 14, 2018

# Growth in Cross-Border Lending

- Cross-border lending has increased dramatically over the last 30 years from nearly $1.7 trillion in 1995 to over $7 trillion today.
- As international transactions become more and more common and expand into an increasing number of jurisdictions, new entrants into the market, and even many of the familiar players, are dealing with complex issues unique to the cross-border market.

The focus of this webinar is to examine these issues, and to consider solutions which will enable both borrowers and lenders to operate efficiently and safely in this huge, growing and vital market.

# Cross-Border Lending

- Cross-border lending pertains to a very broad range of transactions, some of them quite technical (e.g. credit-enhanced trade financing) and some raising particular risks (e.g. project financing in emerging markets).

# Hypothetical Deal Structure-- HoldCo

The borrower ("HoldCo"), a Delaware corporation headquartered in Chicago, is a holding company engaged, through subsidiaries, in a manufacturing business.

HoldCo has a sophisticated domestic capital structure that includes

- syndicated term and revolving secured credit facilities (NY bank as agent, lenders include mostly U.S. banks and US branches of non-US banks) governed by New York law
- unsecured high yield debt securities governed by a "typical" New York law indenture.

# Hypothetical Deal Structure (cont.)

HoldCo has a number of subsidiaries, direct and indirect, including:

- Domestic wholly owned subsidiaries operating in multiple U.S. states
- Domestic majority-owned subsidiaries with minority interests mostly held by shareholders from whom the business was acquired

HoldCo is acquiring a large competitor ("Target") incorporated in England and headquartered in London with a large share of the market in the EMEA region

Target is well known and its brand name is a valuable asset. Further, its manufacturing processes are unique and are closely guarded secrets but are not patent protected

# Hypothetical Deal Structure--Target

Target has for many years operated through two wholly owned subsidiaries:

- a French umbrella company ("FrenchCo") that conducts business directly (manufacturing as well as R&D) in France and owns all the equity of subsidiaries operating across Africa
- a Dutch holding company ("DutchCo") that owns all the equity in all other subsidiaries of Target across the rest of Europe and the Middle East (HoldCo believes they are all wholly-owned, but the due diligence file is incomplete for some of them)
- Each of FrenchCo, and its subsidiaries and the subsidiaries of DutchCo own significant tangible and intangible assets in the markets where they operate
- HoldCo is putting in place a comprehensive debt financing package to fund the acquisition and refinance much, but not all, of the debt of Target and its subsidiaries.

# Key Concepts—Political Risk

**Political risk**: the risk that the law of a particular country

- is not completely spelled out in its written laws
- will change in adverse ways during the life of the transaction, or
- is administered by a judiciary system that lacks integrity and favors local economic/political interests over the legal rights of foreign entities

# Key Concepts—Political Risk

**Legal Risk**: the risk that the commercial bargain reflected in contracts will not “hold” because

- the choice of governing law is partially or entirely disregarded,
- the application/interpretation of contracts will not follow the meaning of the written words as a result of local law and practice,
- the enforcement mechanisms needed to enable creditors to exercise the remedies they bargained for are inefficient, slow and unpredictable and will not be enforced in the manner expected

# Key Concepts– Country Risk

**Country Risk**: a pricing-focused, “more-art-than-science” quantification of the combined effect of political risk, legal risk, currency risk, sovereign debt spreads, “ease of doing business” and the overall likelihood that a country’s economy will experience severe stress

# Key Concepts--Examples

- For centuries the United Kingdom was #1 or 2 for low political, legal and country risk – then we had Brexit…
- Greece, Portugal, and Ireland were not too long ago considered low risks, at least relatively – then we had the sovereign debt crisis and the very real possibility of the Euro falling apart
- Argentina was the poster child for country risk coming home to roost somewhat unexpectedly – today a number of countries in Europe and the Americas seem one election cycle away from “messy” changes relating to their relations with other countries and international organizations not to mention the enforcement of the Rule of Law

# Structuring Considerations

- A few more facts about HoldCo's current debt:
  - New York law governs all but a few collateral documents
  - All domestic wholly-owned subsidiaries guarantee both bank and bond debt
  - Majority owned subsidiaries do not guarantee bank and bond debt, but are dealt with appropriately in the affirmative and negative covenant package
  - Typical high yield indenture (incurrence-based covenants with customary baskets for additional debt, investments, dividends, etc.)
  - All-in, state-of-the-art U.S, consolidated credit facilities, but not structured for a truly "global" borrower, so some structuring features (e.g. negative pledges, springing guarantees to ensure structural parity, prohibitions on expatriation/repatriation of cash, etc.) will need attention

# Structuring Considerations (cont.)

The new term and revolving credit agreement ("Credit Agreement"):

- must co-exist with, but be separate from, HoldCo's current debt
- may have a European arranger and a less U.S.-centric lending group
- will require guarantees from HoldCo and many, if not all, its U.S. subsidiaries to ensure efficient pricing
- will have to leave FrenchCo's assets largely insulated because of legacy secured loans which would be very costly to refinance – though there may be a way to give the new lending group a junior position under French law if a separate facility is put in place and an intercreditor agreement can be worked out with the existing French banking syndicate
- will require FrenchCo's African subsidiaries and DutchCo's EMEA subsidiaries, including tangible and intangible assets and receivables, as part of the collateral package because they are the crown jewel of Target, which generate significant free cash flow from operations, although earning are in local currency

# The Playing Field

- HoldCo's U.S. counsel is very strong in all the relevant disciplines, including tax, but does not have offices in London, Paris, Amsterdam or any of the EMEA jurisdictions where Target operates
- HoldCo's counsel has lined up counsel in London, Paris and Amsterdam to help with due diligence and negotiation of the acquisition documents, but those lawyers have not really been involved on the financing side
- Target has local counsel in most of the EMEA countries where its subsidiaries operate, but none of them has been active in the deal up until now and neither HoldCo's management nor its counsel has even met them
- There is no "financing out" in the acquisition agreement and the commitment papers provide for a tight timetable and very, very expensive bridge financing if HoldCo is not able to put in place the new term and revolving credit facilities

## Governing Law

- Ideally the Credit Agreement will be governed by New York law, which is predictable and accommodates cross-border transactions even if contacts with New York are not particularly strong.
- New York General Obligations Law Section 5-1401 permits parties to choose New York law in a transaction involving at least $250,000 even though the transaction has no relationship with New York:

# NY General Obligations Law § 5-1401

*The parties to any contract, agreement or undertaking, contingent or otherwise, in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate not less than two hundred fifty thousand dollars, including a transaction otherwise covered by subsection one of section 1-105 of the uniform commercial code, may agree that the law of this state shall govern their rights and duties in whole or in part, whether or not such contract, agreement or undertaking bears a reasonable relation to this state. This section shall not apply to any contract, agreement or undertaking (a) for labor or personal services, (b) relating to any transaction for personal, family or household services, or (c) to the extent provided to the contrary in subsection two of section 1-105 of the uniform commercial code.*

# Governing Law

- The European arranger/syndicate may require that the Credit Agreement be governed by English law, which is also predictable and accommodating
- HoldCo and U.S. subsidiaries' guarantees should be governed by New York law, which should work with both a NY and an English law Credit Agreement
- FrenchCo and DutchCo guarantees would be governed by their respective laws, or could be governed by English law if the Credit Agreement is
- Upstream guarantees by operating subsidiaries throughout EMEA will be governed by local laws, if required, or by English law, although lenders may not place an enormous value on those guarantees and will likely rely on alternatives to ensure collectability of claims against the assets of those subsidiaries; examinations of these alternatives and their effectiveness will be key (see below regarding structuring collateral package)

# Forum Selection

New York General Obligations Law Section 5-1402 permits the parties to choose New York state courts where the transaction is governed by New York law and the transaction involves at least $1,000,000:

# NY General Obligations Law § 5-1402

- *Notwithstanding any act which limits or affects the right of a person to maintain an action or proceeding, including, but not limited to, paragraph (b) of section thirteen hundred fourteen of the business corporation law and subdivision two of section two hundred-b of the banking law, any person may maintain an action or proceeding against a foreign corporation, non-resident, or foreign state where the action or proceeding arises out of or relates to any contract, agreement or undertaking for which a choice of New York law has been made in whole or in part pursuant to section 5-1401 and which (a) is a contract, agreement or undertaking, contingent or otherwise, in consideration of, or relating to any obligation arising out of a transaction covering in the aggregate, not less than one million dollars, and (b) which contains a provision or provisions whereby such foreign corporation or non-resident agrees to submit to the jurisdiction of the courts of this state.*

# Forum Selection

- Some banks will not agree to exclusive forum selection in New York or London
- Proper submission to jurisdiction is critical
- Statutes and treaties governing recognition and enforcement of foreign judgments, and choice of law/forum selection, should be stress-tested to ensure as seamless a framework as possible for enforcement of contracts and attachment of assets
  - Enforcement of foreign judgments in New York
  - Enforcement of New York judgments in London, Paris or Amsterdam
  - Enforcement of any judgments against assets of EMEA operating subsidiaries
- Important parts of the lenders' rights will be governed by French and Dutch law because FrenchCo and DutchCo conduct their own business and control the business of their subsidiaries, the equity interests in which will likely be pledged under French and Dutch law documents
- Consider mandatory arbitration to centralize all disputes in a single, neutral, risk-free venue

# Guarantees

- Parent company downstream guarantees
- Subsidiary upstream guarantees
- Sister company cross-stream guarantees
- Recourse to guarantors in low-risk jurisdictions like the U.S., England, France or The Netherlands are a strong credit enhancement if done correctly
  - Governing law (local vs chosen)
  - "Financial assistance" and similar procedures under non-U.S. law required to make the guarantee enforceable are often very technical and cumbersome
  - Secured guarantees need to integrate the guarantee of payment with the remedies against collateral
  - In some jurisdictions guarantees of payment (which are the norm in the U.S. and Europe) are less common than guarantees of collection and local counsel should ensure everything is done to make the guarantee one of payment

# Foreign Subsidiary Guarantees

- The "Deemed Dividend Rules" under IRC § 956 may cause the current and accumulated earnings of a foreign subsidiary to be deemed to have been distributed to its US parent at the time a loan is made
  - if the subsidiary guarantees the debt of the US parent or
  - grants a lien on its assets to secure such debt or
  - two-thirds of the voting stock of such subsidiary is pledged to secure such debt.
- If the foreign subsidiary is not profitable or the earnings have already been repatriated or taxed, then an upstream or cross-stream guarantee may have no adverse tax consequences for the US parent.
- Recent tax law changes also affect the analysis.

# Overseas Shipholding Group v. Proskauer

A recent case *Overseas Shipholding Group, Inc. v. Proskauer Rose, LLP,* 130 A.D.3d 415 (1$^{st}$ Dep't 2015) highlights the risks involved in not considering tax issues at every step of a deal.

Plaintiff suffered a $463 million tax liability as a result of amendments to its financing documents which resulted in the US parent and its foreign subsidiaries being jointly and severally liable on its debt obligations.

Plaintiff filed for bankruptcy in 2012.

Plaintiff then sued its counsel in March 2014.

The court denied a motion to dismiss the legal malpractice claim and the appellate court upheld the denial.

Plaintiff and Defendant settled the lawsuit in February 2016.

# Structuring the Collateral Package

- Much of the tangible and intangible collateral will be located in EMEA countries and liens will have to be perfected (and may have to be created) under local law.
- Local counsel should be consulted to understand the requirements for creating and perfecting a security interest as well as the limitations on the effectiveness and scope of such interests. In many jurisdictions there is no effective means to determine the priority of a security interest.
- Foreclosing on collateral using local courts under local law security agreements may be cumbersome, slow and/or unreliable, so lenders typically use a combination of tools to create “exit strategies” that do not involve foreclosing on collateral in a myriad of local jurisdictions.

# Offshore Share Pledges

- A standard “exit strategy” tool is to obtain a pledge of stock of subsidiaries
  - HoldCo pledges Target stock,
  - Target pledges FrenchCo and DutchCo stock,
  - FrenchCo and DutchCo pledge their subsidiaries’ stock
- Top to bottom structure gives the lenders options to foreclose at different levels and may allow foreclose on equity under the law of a risk- free jurisdiction
- Sale of pledged stock should enable disposition of valuable parts of the collateral package efficiently as “going concerns”
- Foreclosure should put the lenders in the position to take control of local operations through the management chain although there are risks in “running the business”
- BUT local law for the entity whose equity is pledged should be checked to be sure that these routes to exercising creditors’ rights are in fact available.  Beware of local law requirements trumping/stunting the efficacy of the pledge

# Offshore Share Pledges

- The cooperation of directors/management (or the right to replace them) following foreclosure on a pledge is critical, so local counsel should advise on both law and practice in terms of what can be pre-ordained to be sure the lenders have the ability to effect change of management post-foreclosure and also should advise on the rights and liabilities of lenders when they control management.

- The Deemed Dividend Rules may limit the pledge of the foreign subsidiary stock to 65% of the voting stock. Such limit may make it difficult to effectively exercise control over the foreign subsidiary or to realize substantial value from a sale or liquidation.

# Account Receivables

- In many non-US jurisdictions a pledge of accounts receivables may require notice to the obligor of the receivable when the obligation is generated.
- In some jurisdictions this notice has to be issued by a governmental agency and in some cases a court. Such notices are impractical when the receivables are smaller and generated on a continual basis.
- One solution is to require payment from the obligors/customers into a lockbox account. The location of the account and the borrower’s access to the account is usually heavily negotiated. Depending on the currency of payment, the account might be set up onshore and swept into other onshore and offshore accounts.

# Offshore Collateral Accounts

- The effectiveness of “offshore collateral accounts” depends on whether intangible assets/cash can flow seamlessly into and be held in a pledged account in a risk-free jurisdiction.
- Local counsel should advise on both law and practice in terms of what can be pre-ordained to be sure that this solution delivers the desired enhancements.
- If any of the accounts are set up as securities accounts, attention should also be directed to the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, which became effective in the US in April 2017. If it is important to ensure that U.S. law applies to the securities accounts, additional provisions may have to be added to the documentation.

# Pincher Move Structuring

- Guarantees, pledges of equity, collateral accounts and liens on local assets work together to enable lenders to exercise maximum pressure in multiple jurisdictions if remedies need to be exercised
- Perfected liens should ensure priority over other creditors under local law
- The ability to exercise remedies in upstream entities should facilitate the exercise of rights and remedies in downstream entities, ideally permit liquidation of collateral in the most advantageous way

# Model Law on Secured Transactions

- July 1, 2016 the UN Commission for International Trade adopted the UNCITRAL Model Law on Secured Transactions.
- Model Law deals with security interests in all types of movable property
- Unitary approach for security interests
- Model Registry Provisions provide for registration of notices of security interests in a publicly accessible registry to make security interests effective against third parties and to determine priority of competing claimants
- Model Law is expected to have a beneficial impact on the availability and cost of credit, particularly to small and medium-size enterprises in developing countries.
- Purpose is to assist in market inclusion and alleviation of poverty, contributing to Goal 1 of the 17 Sustainable Development Goals of the UN

# Model Law on Secured Transactions (cont.)

- **Choice of Law:**
  - The law applicable to the mutual rights and obligations of the grantor and secured creditor arising from their security agreement is the law chosen by them and, in the absence of a choice of law, the law governing the security agreement.
  - The law applicable to the creation, third-party effectiveness and priority of a security right in a tangible asset is the law of the State in which the asset is located.
  - The law applicable to the creation, third-party effectiveness and priority of a security right in a tangible asset of a type ordinarily used in more than one State is the law of the State in which the grantor is located.
  - The law applicable to the creation, third-party effectiveness and priority of a security right in an intangible asset is the law of the State in which the grantor is located.

# Other Credit Enhancement

- Credit support from governmental and quasi-governmental institutions in the various jurisdictions: indirect guarantees, letters of credit, export credit, trade financing and other programs can reduce the risk associated with particular obligors
- Political risk insurance: if available, provides the credit of institutions in risk-free jurisdictions for the most extreme occurrences of country risk, like currency changes or expropriation
- Credit default swaps: the market for derivative contracts has become deep, creative and flexible, if pricing is not inefficient or volatile, and could de-risk the loans with an acceptable impact on yield for the lenders

# Concluding Thoughts

- Devices used to reduce loan exposure (e.g. HoldCo's and U.S. subsidiaries' guarantees of foreign loans) might trigger breaches under HoldCo's existing bank or bond debt
- Upstream and downstream guarantees may face legal impediments, trigger negative economic or tax consequences
- The crafting of the best collateral package (e.g. pledges and liens on FrenchCo's assets) may conflict with existing debt that cannot be refinanced or amended
- While some creditors will have an incentive to "play ball" (e.g. the U.S. agent under current bank debt and U.S. syndicate members will want the largest share possible of the new foreign facilities), others may not (e.g. the French banking syndicate that finances FrenchCo)
- Some creditors (e.g. U.S. bondholders) cannot as a practical matter "participate" in the process because consent solicitations are time-consuming, expensive and uncertain

# Thank you

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