Shoring Up Distressed Cross-Border Loans

Although the general approach for dealing with troubled credits with a cross-border component is similar in many respects to the approach for purely domestic U.S. loans where all of the loan parties and collateral are located in the United States, the presence of foreign parties or assets gives rise to additional considerations. The discussion presented here highlights some of those considerations.

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In this troubled economic climate, many lenders may find themselves with distressed loans in their portfolio that have a cross-border component. One or more of the borrowers or guarantors, or some of the collateral, may be located outside of the United States. Or the borrowers, guarantors and collateral may all be located in the U.S., but there may be foreign affiliated companies or assets that were not part of the original loan structure due to cost considerations, the absence of a perceived need for such additional collateral or other factors. Although the general approach for dealing with troubled credits with a cross-border component is similar in many respects to the approach for purely domestic[1] U.S. loans where all of the loan parties and the collateral are located in the United States, the presence of foreign parties or assets gives rise to additional considerations.

As in the case of a domestic U.S. loan, a prudent lender with a distressed cross-border loan will engage in two analyses. First, the lender will determine its rights with respect to the loan parties and their assets in order to prepare for a possible workout or insolvency proceeding. Second, the lender will evaluate whether there may be ways for it to "shore up" its position, such as by adding collateral, or addressing a potential weakness in the loan structure or its rights in the collateral.

In the case of a cross-border loan, the first analysis will, among other things, require the lender to:

- Make certain that its security interests are properly perfected under the laws of each relevant country;
- Reaffirm its understanding of enforcement procedures applicable to each of its security interests; and
- Evaluate the insolvency laws in each country in which insolvency proceedings are likely to be commenced.

The second analysis includes identifying any "free" (that is, unencumbered) foreign assets in which security interests might be obtained. This analysis can be especially fruitful where, as a result of sensitivity to the tax concerns of the borrower at the time the loan was first made, the foreign collateral consists only of pledges of 65% of the shares of the first-tier foreign subsidiaries (more fully discussed below). If free assets are available, the lender will need to consider the types of rights to the assets that it can obtain under applicable law and whether such rights, once obtained, may be vulnerable to attack under applicable preference or other avoidance laws (which may, but will not necessarily, be laws of the country in which an insolvency proceeding is filed).

Apart from the obvious benefit of providing the lender with additional collateral, shoring up a loan with foreign collateral can have another, less obvious, benefit: it can enhance the lender's position in the event of a sale of the borrower's business in its entirety in an insolvency proceeding. In those countries where an insolvency official manages the sale process, the more assets a lender has liens on, the better position the lender will be in to claim a larger share of the sale proceeds reflecting the going concern value of the enterprise. This is especially true where the additional collateral consists of the borrower's intellectual property, to which significant value is often attributed by insolvency administrators in battles over the allocation of sale proceeds.

The shoring up may also involve restructuring the loans, by adding one or more new borrowers or guarantors, or converting one or more guarantors to borrowers (which may necessitate making new loans to such entities), or vice versa.

Regulatory Considerations

Often, in the process of shoring up its position, the lender will need to consider the applicable foreign regulatory regime. Where the shoring up involves making new loans to a foreign entity, the issue is whether the U.S. lender is required to obtain a license or other regulatory approval from the appropriate governmental authority in the entity's jurisdiction in order to be permitted to make the loans, or whether the lender may be subjecting itself to taxes in that jurisdiction by making the loans. In many countries, no license or approval is required in the case of a "one-off" loan facility to a domestic company, while multiple loan facilities may necessitate obtaining a license (Canada). On the other hand, in some countries the lender will need to qualify by demonstrating a certain level of lending activity (The Netherlands). Sometimes, actively marketing in a country requires a license (Germany). In other countries, foreign lenders cannot lend to a domestic company without the express approval of the government (India).

Where the shoring up involves obtaining liens on foreign assets, in many countries it is possible for a U.S. lender to obtain liens on assets located in the country, or owned by a domestic company, without any special license or regulatory approvals. In some countries, governmental approval will be necessary with respect to certain types of collateral (such as a share pledge in India, which requires the approval of the Reserve Bank of India, or any assets in China). In other countries, it may not be possible to obtain a lien on certain types of collateral at all (such as arable land in Hungary). The fact that you are permitted to obtain a lien on a assets in a given country does not necessarily mean that you will be permitted to make a loan to a company organized in that country. In such circumstances, the liens on the assets may have to secure a guarantee rather than direct loans.

Liens on Specific Types of Assets

The issues that a lender confronts in taking additional non-U.S. collateral or in evaluating its position as to existing non-U.S. collateral depends, in part, on the type of asset involved.

Accounts Receivable

Assume a lender has a borrower with

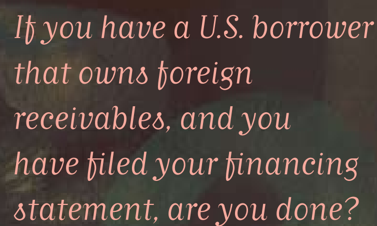
1 In this article, the term "domestic," when used with reference to a particular country, refers to that country. For example, when referring to France, the term "domestic company" or "domestic guarantor" refers to a company organized in France.

receivables due from customers scattered around the world. Perhaps the transaction was originally structured so that the lender was to obtain rights to the receivables owing by the various non-U.S. customers. Or, perhaps the borrower is now in trouble and the lender is looking at the non-U.S. receivables either as a source of additional liquidity for the company by including them in the borrowing base, or simply by taking them as additional collateral (perhaps to help plug a shortfall caused by plummeting inventory values). If the transaction was structured at the outset with the objective of giving the lender a security interest in the non-U.S. receivables, what does the lender now need to do to make sure that it has the rights it thought it had? Or, if the receivables from the non-U.S. customers were not part of the original collateral package, what should the lender do to obtain rights in them?

First, the lender has to determine the jurisdiction whose law will govern the creation of its rights. This determination starts with the simple step of confirming whether the receivables are owned by a U.S. company or a foreign company. Don't be fooled by comments about where the invoices are generated. Find out who owns the inventory whose sale gives rise to the receivables. If a U.S. company owns the inventory, then clearly the lender needs to take its customary steps under U.S. law to obtain a security interest in the receivables arising from its sale. If a foreign company owns the inventory, the lender needs to take the steps required under the laws of the jurisdiction in which the foreign company is organized in order to obtain a security interest in the receivables.

Is compliance with the laws of the country in which the owner of the receivables is organized sufficient? If you have a U.S. borrower that owns foreign receivables, and you have filed your financing statement, are you done? This is the point in the analysis where matters become complicated. Depending on various factors of private international law (the law determining which country's laws govern a particular transaction), the answer very likely may be that, to achieve the greatest certainty as to its rights, the lender will want to comply with the laws of the jurisdiction in which the customer is located, as well as the laws of the jurisdiction where the owner of the receivables resides. If the customers are located in a large number of jurisdictions, the lender may wish to consider establishing its rights only as to receivables due from customers in those countries where there is a significant concentration of receivables in order to make the matter manageable from a cost or administrative standpoint.

For each jurisdiction where the owner of the receivables is located, and likely also for those jurisdictions where the customers obligated on such receivables are located, the lender may need to consider (i) whether it is necessary to have a separate security document executed and delivered for each receivable or group of receivables that exist at any given point in time (in some jurisdictions an executed security instrument can only cover receivables that exist at the time, and not future receivables), (ii) whether notices to the customers of the secured lender's rights are required and if so, the form the notice must take, and (iii) whether waivers of prohibitions on the pledge or assignment of the borrower's rights in the receivable that are part of the underlying contract between the borrower and its customer are necessary. As for this last consideration, unlike the U.S., where the Uniform Commercial Code renders such provisions unenforceable, terms in the contract between the buyer and seller of goods or services that prohibit an assignment of, or granting a lien on, the receivables arising under such contract are enforceable under the laws of many other countries.



Inventory

Where the collateral includes inventory located outside the U.S., it is important to remember that, unless the inventory is covered by warehouse receipts or other documents of title, the perfection and priority of a security interest in the inventory generally will be governed by the law of the country in which the inventory is located. Therefore, the prudent lender should verify where the inventory is located, and make certain that all appropriate requirements for the establishment of its rights to such inventory as collateral have been satisfied. Depending on the law of the country involved, this may include, among other things, the filing of a notice of the security interest in the appropriate lien registry (Canada, New Zealand), the filing of the security agreement itself (England), possession of the inventory (Switzerland) or keeping the inventory in a designated location (Germany).

An important consideration in the case of inventory is the existence of retention-of-title claims. Retention of title, which is accepted practice in European jurisdictions, is a critical challenge for international secured lending based on inventory. In its simplest form, retention of title (sometimes also referred to as "reservation of title") occurs when the supplier of goods to the borrower continues to own the goods held by the borrower until the supplier is paid for them. In almost every country where retention of title is recognized, it arises by reason of a clause included in the contract of sale for the goods (whether appearing in the purchase order, on the back of the invoice or in a stand-alone "master" contract).

Perhaps the easiest way for a U.S. lender to think of retention of title is to compare it to the Uniform Commercial Code's "purchase-money security interest" ("PMSI"), except that unlike a PMSI, which is folded into the UCC and requires the filing of a financing statement, retention of title only requires

that the terms be included in the contract between the borrower and its supplier, and the supplier's right to the goods always has priority over the rights of the secured lender.

Not only are there various types of retention-of-title clauses, but the clauses are enforced differently, depending on the particular jurisdiction. In most jurisdictions, the rights of the supplier will be cut off once the goods are integrated and commingled with other goods so as to lose their separate identity. A secured lender must understand how retention of title is construed in the jurisdictions applicable to its inventory collateral in order to be able to determine whether it may only have to exclude raw materials from its borrowing base, or certain work-in-process in addition. Because the rights of the seller of goods pursuant to its retention of title is set forth in the contract between the seller and the borrower (the buyer), it is necessary to review such contracts for these clauses, recognizing that this does not necessarily eliminate the risk since such contracts may change after the loan closes.

Additional considerations concerning inventory located in other countries include determining whether there are any vendor reclamation claims under applicable law (Canada) and making certain that landlord's agreements are in place where possible (though it may be more challenging to obtain such agreements in countries other than the U.S. where the practice of obtaining them is less well-established).

An additional issue concerning inventory arises in the United Kingdom and certain other countries whose law is based on U.K. law (such as Australia, Hong Kong, Malaysia and Singapore). In these jurisdictions, security interests in personal property often are created using a "fixed and floating charge": a "fixed charge" attaches to assets that the borrower is not permitted to dispose of without the lender's consent (such as real estate and equipment), while a "floating charge" attaches to assets that the borrower is permitted to dispose of without the lender's consent (such as inventory that the borrower is authorized to sell in the ordinary course of its business).

When shoring up a distressed loan with a pledge of shares or other equity of a foreign company, good practice requires that the law of the issuer of the shares or equity should dictate the form of the pledge agreement.

As for receivables, current U.K. case law requires that the lender have "control" over the proceeds of the receivables in order to create a "fixed charge" over the receivables. The required level of control is most clearly achieved when the proceeds are required to be paid into a lockbox or blocked account by the customers and are automatically applied to reduce the outstanding loan (subject to reborrowing in accordance with the terms of the loan agreement). The distinction between a "fixed" charge and a "floating" charge relates principally to priority: a fixed charge generally gives the lender a first-priority right in the charged assets, while a floating charge may not have priority over the claims of certain other creditors, such as certain government claims, or even claims of unsecured creditors to a certain extent (as discussed below).

Equipment

The considerations concerning equipment are similar in many respects to those relating to inventory. Perfection and priority of the security interest are governed by the law of the location of the equipment, which may include: filing or registration of a notice of the security interest or the document itself; possession; location in a designated area; or possibly tagging of the equipment with a notice of the security interest. Retention-of-title claims in favor of the vendor often also apply to equipment, and landlord's agreements are important to obtain where available.

However, equipment differs from inventory in certain respects. First, it is unlikely that the supplier of the equipment will have reclamation claims, as might be the case with inventory. Second, as noted above, in countries where fixed and floating charges are used, it is generally possible to obtain a fixed charge on equipment.

Real Estate

In most countries, it will be possible to obtain a lien on real estate, although there are some exceptions. Local law will, of course, govern. In some countries, there may be more than one security device available, and care must be taken to select the best one. Also, title insurance, which is a cornerstone of real estate lending practice in the U.S., is not commonly used in some other countries.

Shares

When shoring up a distressed loan with a pledge of shares or other equity of a foreign company, good practice requires that the law of the issuer of the shares or equity should dictate the form of the pledge agreement. Thus, for example, when taking a pledge of the equity in a German limited liability company known as a GmbH, a German form of pledge agreement should be used. By contrast, the approach of using a U.S. form of pledge agreement "for what it's worth" in order to minimize legal expense often deprives the lender of any special waivers, as well as unique enforcement procedures and other rights under local statues, available when using a "local" document, and may even result in the pledge agreement being unenforceable for failing to satisfy the requirements of the law of the jurisdiction in which the company is organized.

In many distressed cross-border loans — especially those documented in the more exuberant credit markets of the past few years — the foreign collateral consists entirely of pledges of 65% of the shares of the U.S. borrower's first-tier foreign affiliates. These pledges generally were taken in lieu of pledges of 100% of the shares of the issuer's foreign affiliates (first-tier or lower), guaranties by the foreign affiliates, and liens on the assets of the foreign affiliates, in order

to avoid triggering a potential "deemed dividend" under §956 of the U.S. Internal Revenue Code. As discussed below, in a distressed context, it may be possible for the lender to increase the 65% share pledges to 100% and also to obtain such guaranties and liens.

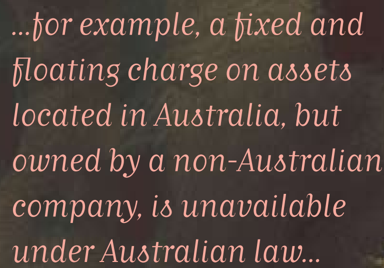
Intellectual Property

Intellectual property owned by the borrower or its affiliates may play an important role in shoring up a distressed cross-border loan. Unencumbered patents, trademarks, copyrights and other "IP" can provide valuable support as collateral, assuming that it is possible to obtain an enforceable security interest in such property. Also, as noted above, having a lien on a company's intellectual property is increasingly important in disputes concerning how the proceeds of the sale of the company in an insolvency proceeding will be allocated.

Where the borrower's business relies heavily on its intellectual property, a lender should, at the first sign that the loan is in trouble (if not sooner) consider conducting an "IP audit" to make certain that each company in the borrower's corporate group either owns, or has a license to use, all of the intellectual property it needs in the operation of its business. This enables each company to be sold separately as a going concern, a circumstance that can be quite important if the members of the corporate group become the subject of separate insolvency proceedings in different countries (as opposed to a single insolvency proceeding in one country in which all of the companies are jointly administered).

Blanket Liens

In some countries, it is possible to obtain a security interest in substantially all of a company's assets by means of a single security device granting a blanket lien (often referred to as an "enterprise mortgage," though the "fixed and floating charge" discussed above also fits within this category). It should be noted, however, that these security devices may be less comprehensive than they appear at first blush. For example, in some countries they may not be available to certain lenders (for example, a Belgian "pledge of the entire business" is only available to an EU financial institution). Or, they may not be available for certain borrowers (for example, a fixed and floating charge on assets located in Australia, but owned by a non-Australian company, is unavailable under Australian law). In addition, there may be a carve-out for certain unsecured creditors (as in the U.K., Finland and Sweden).



These limitations must be taken into account when shoring up a loan using these security devices, though often "work-around" strategies may be available to blunt the adverse impact of such limitations.

Priority Issues

Apart from retention of title, what else will a secured lender need to consider when determining the amounts it might recover from foreign collateral? The lender will need an understanding of the potential claims that may have priority over its rights in the collateral. If the foreign assets are to be included in the borrowing base, the lender will have to establish reserves, perhaps adjust advance rates, and identify ineligible assets as a consequence of the priority of its rights vis-à-vis other creditors that may claim an interest in the assets.

When it comes to relative priorities among secured creditors, no matter where you are in the world, the general rule is going to be "first in time." But to simply say "first in time" begs the question: first to do what? There are several different ways that the world's legal regimes establish priorities among secured lenders. The most common possibilities include (i) "creation," which refers to the time when the security right is established by the execution and delivery of the security document, (ii) "registration," which of course only applies in those countries that have a lien registration system (some do not), or (iii) "notification," meaning the time when the account debtor is notified of the pledge or assignment.

There are a number of countries that provide, by statute, for a certain portion of the assets of a borrower subject to an enterprise mortgage or other blanket lien to be set aside for the benefit of unsecured creditors, and therefore to be unavailable to repay the debt owing to the secured lender. In such jurisdictions, some of the proceeds from the realization on assets will go to unsecured creditors rather than the secured creditor.

The United Kingdom, with the Enterprise Act 2002, established a "ring-fenced" interest in the assets of a debtor for this purpose, limited however to the lesser of (i) 20% of the debtor's "net property" (that is, property left over after subtracting the value of property that is subject to a fixed charge, the amount of required payments to preferential creditors, and costs of realization on the assets of the debtor) and (ii) £600,000. Belgium, Sweden and Finland are other examples of countries whose laws provide for a carve-out for unsecured creditors from the share of assets that might otherwise be available to the secured lender.

Not unlike a U.S. bankruptcy case, where there is often a "carve-out" for fees and expenses of professionals for the debtor and the creditors' committee engaged in the case, in other countries it is not uncommon for expenses of insolvency officials (often court-appointed officials depending on the jurisdiction) to be entitled to their fees and expenses with priority over all other claims. In Germany, this can be significant, since by statute the German insolvency administrator is entitled to fees of at least 9% of the proceeds from the disposition of the collateral, and it can be more if the job of the administrator in realizing on the

collateral is particularly difficult or involved. In some jurisdictions, while such fees and expenses do not have priority by statute, the prudent secured lender will be prepared to cover such expenses to the extent that the insolvency official is part of the process of realization on the collateral — not unlike a chapter 7 trustee in a U.S. bankruptcy case.

Then, of course, there may be other claims that are given priority, most commonly in an insolvency proceeding, that must be considered depending on the jurisdictions involved. These may include, for example, claims relating to taxes, employee wages and benefits, environmental claims, and amounts owing to landlords, warehouses or processors.

I.R.C. §956

Reference has already been made to §956 of the U.S. Internal Revenue Code, a provision that can be extremely relevant when shoring up collateral in a distressed loan. Under §956, a "deemed dividend" on previously untaxed earnings and profits of a foreign subsidiary of a U.S. company is triggered when a loan to the U.S. company is secured by (i) a guarantee by the subsidiary, (ii) a lien on the subsidiary's assets or (iii) a pledge of two-thirds or more of the subsidiary's shares (along with a negative pledge on the right of the subsidiary to dispose of its assets).

As noted above, accommodating the borrower's desire to avoid triggering such a deemed dividend is the reason why the collateral for many cross-border loans is limited to a pledge of only 65% of the shares of the first-tier foreign subsidiaries. Although a detailed discussion of §956 is beyond the scope of this article, there are a variety of reasons why, when such a loan becomes distressed, §956 may become less of a concern. For example, the borrower may have significant losses and net operating loss carry-forwards that can offset the adverse tax consequences of any deemed dividends, or the borrower may have begun repatriating the earnings of its foreign subsidiaries to support lagging U.S. operations, thereby triggering actual (as opposed to deemed) dividends. Alternatively, the lender may now feel that the interest of shoring up its loan outweighs its desire to accommodate the borrower's tax considerations. Moreover, there may be other strategies available to the parties which blunt the impact of §956 and leave fewer assets on the table.

Guaranties

The liens on assets outside of the United States will secure either a direct loan or a guarantee. As the borrower's performance deteriorates and the lender looks for ways to reduce its risk and enhance its recovery, the lender will most likely not want to make additional loans; thus, a guarantee from the foreign subsidiary secured by such assets would seem the most desirable way to accomplish the lender's objectives. But will the guarantee be enforceable under the laws of the foreign company's jurisdiction? If it is not enforceable, then the lender will not have recourse to the assets of the foreign company that secure the guarantee.

The answer to this question will often depend on the relationship between the guarantor and the borrower. In the context of a group of affiliated companies, there are, of course, three possibilities: (i) the "upstream" guarantee, where the subsidiary guarantees the debt of its parent, (ii) the "sidestream" guarantee, where an affiliate guarantees the debt of another affiliate and (iii) the "downstream" guarantee, where the parent guarantees the debt of its subsidiary.

U.S. lenders are familiar with the concepts of fraudulent transfer law in the United States that affect the enforceability of guarantees under U.S. law. Not surprisingly, many foreign jurisdictions have similar concepts. As in the U.S., the laws of many jurisdictions generally support the enforceability of a downstream guarantee, while upstream and sidestream guarantees may or may not be enforceable depending on various factors, such as the nature of the "benefit" that the guarantor company is deemed to derive from giving the guarantee. Some jurisdictions, such as the United Kingdom, Canada and Mexico, take a more liberal view of the benefit that a guarantor may receive as consideration for the guarantee, while many other countries require that direct and specific economic consideration be received by the guarantor. In general, the laws concerning the enforceability of guarantees in foreign jurisdictions are as complicated as those in the U.S., and may compel a lender to restructure the loan facility by making direct advances to the foreign company in order to enhance the likelihood that its security interests in the company's assets will be enforceable — an approach that may or may not be viable depending on the circumstances.

Conclusion

While U.S. asset-based lenders may be less enthusiastic about expanding their offerings beyond domestic shores in the current regulatory and economic climate, the increasingly global reach of businesses cannot be ignored. Notwithstanding the fact that obtaining liens on foreign collateral, either at the outset of a loan transaction or at the first sign of distress, adds complexity to the transaction, these assets may provide the lender with important additional avenues for recovery. Lenders alert to the potential importance of foreign assets are likely to find that the additional value inherent in these assets can make a significant difference in their ultimate recovery — perhaps all the difference in the world. TSL

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