



# Further Reflections on International Asset-Based Lending

by Richard M. Kohn

**E**ight years ago, my article entitled “Reflections on International Asset-Based Lending” appeared in *THE SECURED LENDER*.<sup>1</sup> Written at a time when most U.S. asset-based lenders wanted little or nothing to do with international lending, the article was based on the premise that these lenders would become increasingly receptive to international lending as their existing and prospective borrowers became more globalized.

That prediction has come true. In the past eight years, we have witnessed a major shift in the attitude of many U.S. asset-based lenders toward international lending. Driven by necessity or the desire to explore new markets, these lenders have overcome their reluctance to consider international transactions, and international asset-based loans have become much more prevalent. This trend will undoubtedly accelerate as factors such as advances in technology, reductions in trade barriers, the current explosive acquisition activity in Europe, the emergence of the euro, movements to standardize lending laws spearheaded by UNCITRAL<sup>2</sup> and UNIDROIT<sup>3</sup> and the active encouragement of the Commercial Finance Association combine to create an atmosphere in which international asset-based lending can thrive.

Unlike my previous article, which was a survey of legal and practical considerations affecting international asset-based loans, this article focuses on a few issues which deserve special attention because of their inherent importance or the frequency with which they arise. Some of these issues relate to structuring loans, while others relate to obtaining liens on non-U.S. collateral.

ciency, but equally important is the *approach* taken by lenders and their lawyers, especially when structuring the loan.

Agreeing on the structure at an early stage in the transaction, *before* drafting begins, can go a long way toward achieving an efficient and cost-effective closing. This sounds both obvious and easy, but for various reasons it is neither.

First, as in any loan transaction, each party to an international loan has its own agenda in structuring the deal, and often these agendas are inconsistent. The lender's goals may include loaning to where the assets are, obtaining enforceable liens on the assets of all companies in the borrower's corporate group and restricting intercompany loans among those companies. However, in many cases, the lender's goals run directly counter to operating, tax and other considerations important to the borrower.

Second, in many countries the concepts of asset-based financing and leverage buyouts as we know them have only recently surfaced. As a result, the application of principles of non-U.S. law to these concepts is still evolving. This is especially true of issues such as financial assistance and corporate governance (discussed below), which affect the ability of a non-U.S. company to provide a guaranty or a lien on its assets to secure a loan made to its parent or other affiliate.

Third, as in any loan transaction, there is often pressure, arising from marketing considerations or a tight schedule, to begin documentation before the structure is finalized. This can be perilous with international loans, where cross-border issues often have a profound impact on deal structure. Nothing can drive costs up faster than redrafting complex loan documents each time the deal structure changes, particularly when the working team is spread across the world. Unfortunately, like the lost airline pilot who tries to reassure his passengers by announcing "don't worry, at least we're making good time," starting to document before the structure is finalized may result in a false sense of momentum.

Ideally, the working team should concentrate on structural issues until they are fully resolved.

The lender can play a significant role in controlling time and expense by alerting the borrower to significant structuring issues (especially those important to the lender) at the earliest possible stage, *before* the borrower becomes wedded to a particular structure driven by tax or other considerations. A lender who takes this approach is often doing the borrower a favor (though the borrower may not always realize it at the time).



### Structuring an international asset-based loan

*"Measure twice, cut once"*: In spite of the increase in international asset-based lending activity, at least one of the central challenges of international asset-based lending remains the same: How to close these loans in a way that is not prohibitively time-consuming or expensive. Much progress has been made toward meeting this challenge as lenders and their lawyers have gained experience in the area. Still, much more can be done. A good working knowledge of the relevant legal issues is critical to effi-

Consider convening a meeting of all parties and their advisors instead of relying on conference calls and faxes. Although such a meeting initially adds expense, it can save a lot of money later on if it helps to identify and resolve structural issues early in the process. The meeting can also help build relations among the parties and lessen some of the communication barriers that frequently attend international transactions.

Another useful procedure is for the parties to sign a memorandum describing the structure, even supported by opinions of counsel as to the legality of the structure, before documentation begins. Obtaining legal opinions before closing is unusual; however, it forces the parties to focus on structural issues with precision.

Documenting an international loan should be like taking an essay exam – it is wise to spend the first third of your time outlining your answer before you start writing. Carpenters put it another way: “Measure twice, cut once.”

*Financial assistance:* One of the most fundamental legal concepts affecting the structure of an international acquisition loan, especially in Europe, is “financial assistance.” Laws in many countries prohibit a domestic company<sup>4</sup> from giving a guaranty, or a lien on its assets, in connection with the acquisition of its own shares by a third party. These techniques are, of course, used frequently in acquisition financing in the United States, although their use in particular situations will be affected by U.S. fraudulent conveyance laws. However, the application of U.S. fraudulent conveyance laws generally depends on the financial condition of the company providing the guaranty or lien (*i.e.*, whether the company was rendered insolvent), whereas financial assistance laws in many countries prohibit such actions without regard to the company’s financial condition.

The penalties for violating financial assistance laws can be quite severe, ranging from invalidity of the guaranty or lien to criminal sanctions. For example, in Belgium, the directors of the company can be jointly and severally liable for all damages to the company and third parties resulting from the violation, the guaranty or other contract evidencing the financial assistance will be null and void and possible criminal sanctions ranging from a fine of 10,000 to 2,000,000 Belgian francs and imprisonment for one month to one year may be imposed.<sup>5</sup> It is not surprising that financial assistance laws are taken seriously.

In Europe, financial assistance laws were enacted in response to a 1976 Directive of the Commission of the European Economic Community (the predecessor to the European Union)<sup>6</sup> which called upon Member States to enact laws providing that a domestic company “may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party.”<sup>7</sup>


Although all these financial assistance laws

emerged from the same Directive, the laws enacted by the Member States differ in various respects. For example, in England a private company may still give financial assistance if it goes through a procedure referred to as “white-washing,” in which the company’s directors make a statutory declaration that the company is solvent and will continue to be so for at least 12 months, supported by a report of the company’s auditors.<sup>8</sup>

There are also variations in the way the financial assistance laws are interpreted in different countries. For example, in some countries the law is interpreted to prohibit a company from giving financial assistance not only in connection with its own shares, but also in connection with the shares of its domestic parent or grandparent. In other countries, the law is interpreted to apply to any parent or grandparent, wherever organized. Thus, depending on the interpretation, it may be permissible for a non-U.S. subsidiary to give a guaranty in connection with an acquisition of the shares of its U.S. parent. On the other hand, the creation of a holding company in order to avoid the financial assistance laws might be viewed as impermissible. Interestingly, lawyers within the same country sometimes disagree on these issues.

There are also differences among the various laws as to the types of companies to which they apply. For example, in Belgium, the law is applicable to most major commercial corporate entities, including entities bearing the designation *N.V.* or *S.A.* (*naamloze vennootschap* or *société anonyme*) and *b.v.b.a.* or *s.p.r.l.* (*besloten vennootschap met beperkte aansprakelijkheid* or *société privée à responsabilité limitée*). In contrast, in Germany, the law applies only to public companies – the form of company bearing the designation *A.G.* (*Aktiengesellschaft*) and not to the privately held limited liability company known as the *GmbH* (*Gesellschaft mit beschränkter Haftung*).<sup>9</sup>

Another issue is whether these laws prohibit financial assistance in connection with the *refinancing* of indebtedness originally incurred in connection with the acquisition



In Belgium, for example, the answer to this question ... [whether these laws prohibit financial assistance in connection with the *refinancing* of indebtedness originally incurred in connection with the acquisition of shares] ... seems to depend upon the intention of the target.

**... in Germany it is not uncommon to include a provision in a loan agreement or guaranty prohibiting a *GmbH* from making any payment which would cause its net worth to fall below its stated capital.**



of shares. A conservative conclusion that they do may be appropriate where the acquisition debt was incurred with the expectation that it would soon be refinanced. In Belgium, for example, the answer to this question seems to depend upon the intention of the target.<sup>10</sup> However, it is not at all clear that the absence of any plan to refinance, or the passage of time, will avoid the problem.

Although violating financial assistance laws can lead to drastic consequences, these consequences may sometimes be avoided with proper attention at the structuring stage. Here are a few approaches that have been suggested for structuring a transaction in a way that may not violate the financial assistance laws.<sup>11</sup>

- ▶ It is possible that the financial assistance laws may be satisfied if none of the loan proceeds are used to acquire the shares of the target. Instead, the loan proceeds could be used to refinance other debt, or for working capital, leaving the shares to be purchased with equity invested by the borrower's shareholders. Under this approach, great care should be taken to insure that the loan proceeds are never commingled with funds used for the acquisition, and that the debt being refinanced is truly debt (and not disguised equity) and was not originally incurred in connection with the acquisition of shares.
- ▶ It may be possible to restructure the acquisition as an asset purchase rather than a share purchase or, in an appropriate case, as a merger.
- ▶ In some cases, the lender may be content to rely on a pledge of the shares of the target to secure an acquisition loan made to the acquirer and to forego collateral provided by the target.

- ▶ There may be no violation of the financial assistance laws if the selling shareholder, to which the target has previously made a loan, sells its shares in the target to the acquirer at a reduced price and, in connection therewith, that loan is assumed by the acquirer (with the selling shareholder being released).

These approaches only represent possible avenues for further inquiry. Great care must be taken to ascertain that any proposed structure complies with applicable financial assistance laws. Especially in cases of doubt, it is wise to request an opinion of local counsel on the issue.

*Corporate governance:* A second issue of great importance to the loan structure is often referred to as "corporate governance." Here the issue is the ability of a non-U.S. company to guaranty a loan made to its parent company or one of its other corporate affiliates, or to become jointly liable on a loan with its parent or other affiliate. While this issue is similar to the financial assistance issue, it is broader in a sense, because the issue of corporate governance exists whether or not the transaction involves an acquisition of the domestic company's shares.

In many countries, a twofold test must be met in order for a domestic company to become liable for the obligations of its affiliate. First, the domestic company's own interests must be served by doing so.<sup>12</sup> This generally means that an economic benefit must be conferred on the company,<sup>13</sup> or that the company's commercial interests are served in some other way,<sup>14</sup> such as where the guaranty or joint liability enables the company to borrow money based on the creditworthiness of the entire corporate group of which it is a member.

Second, the guaranty cannot impair the company's capital or net worth. For example, in Germany, a *GmbH* (a German limited liability company) may not guaranty, or assume joint liability for, a loan to its parent or other affiliate to the extent it would cause its net worth to fall below its stated capital (although a recent decision of the German Federal High Court of Justice suggests that such a breach of German law does not automatically render such a guaranty or joint liability invalid, unless the lender should have known that the borrower's corporate group was in a precarious financial position or the lender intentionally or knowingly conspired to damage the company or its creditors<sup>15</sup>).

Certain countries have broad exceptions to this issue. For example, in various provinces of Canada, a wholly owned subsidiary generally may guaranty a loan made to its parent or grandparent, although it may only guaranty a loan to a sister corporation if the guaranty will not render the company insolvent.<sup>16</sup>

If a corporate governance issue exists, there may be ways to address it. One approach is to determine the maximum extent to which the company may give a guaranty or assume joint liability under applicable law, and try to work within that limit. For example, in Germany it is not uncommon to include a provision in a loan agreement or guaranty prohibiting a *GmbH* from making any payment which would cause its net worth to fall below its stated capital. Alternatively, the guaranty or joint liability may be expressly limited to a specific dollar amount or percentage of the company's net worth.

A second approach is to restructure the loan in order to increase the extent to which the company uses loan proceeds in the operation of its business. These proceeds presumably benefit the company without impairing its capital or net worth.

A third approach is to explore possible modifications to the borrower's corporate structure. For example, in one transaction it was necessary to include the accounts receivable and inventory of a non-U.S. subsidiary in the borrowing base for a loan to the U.S. parent; however, concerned with corporate governance issues, the subsidiary's directors were unwilling to execute the upstream guaranty which such collateral would secure. The solution was to recommend that the existing accounts and inventory owned by the subsidiary be transferred to its U.S. parent (which was also an operating company) and that all future purchases and sales of inventory be made by the

parent, leaving the subsidiary to operate purely as a sales office. As a result, the upstream guaranty was no longer required, and the corporate governance issue became academic. It turned out that there were other valid business reasons for transferring the accounts and inventory. Moreover, the transfer did not result in out-of-pocket costs for the parent (apart from a relatively modest tax on the transfer). There was a substantial intercompany debt already owing by the subsidiary to its parent, so the transfer could be effected simply by reducing this debt. By focusing on this issue early in the transaction, the parties had ample time to craft a cost-efficient solution that adequately addressed the needs of all parties.

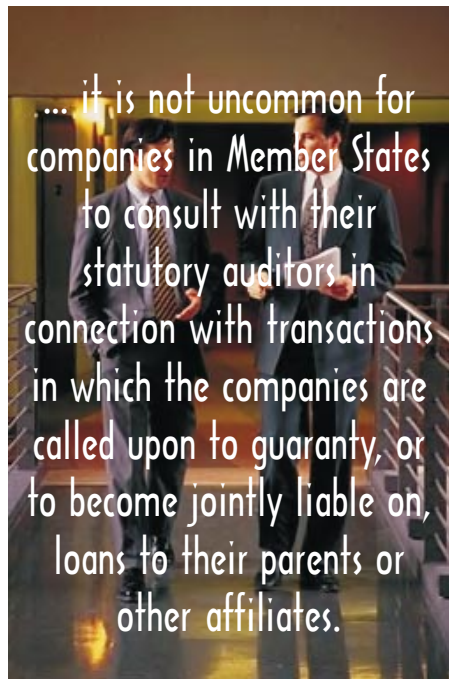
*The statutory auditor:* Overlaying the issues of financial assistance and corporate governance in the European Union is the requirement, created by various Directives of the Commission of the European Economic Community,<sup>17</sup> that each company of a certain size domiciled in a Member State have its annual financial statements audited by a "statutory auditor" appointed by the company. The impetus for this requirement was the desire to ensure that investors, creditors, and other third parties can expect a certain degree of assurance and coverage from the audited financial statements of companies domiciled in Member States.<sup>18</sup>

Although there has been some disagreement concerning the scope of the statutory auditor's responsibilities in different Member States,<sup>19</sup> it seems to be generally accepted that its role includes detecting and reporting upon breaches of applicable company law<sup>20</sup> (which presumably includes financial assistance laws) and alerting the company to circumstances which could impair the company's ability to continue as a going concern<sup>21</sup> (with specific duties ranging from qualifying its audit report to playing a more

active role in preventing the company's business failure).

As a result, it is not uncommon for companies in Member States to consult with their statutory auditors in connection with transactions in which the companies are called upon to guaranty, or to become jointly liable on, loans to their parents or other affiliates. Although this process can be time-consuming and frustrating, an approval of the transaction by the statutory auditor can provide a high degree of comfort for all parties to the transaction. To minimize unnecessary delays in the later stages of a transaction, it is important to involve the statutory auditor in the early structuring phase.

*Selected tax issues:* Many international acquisitions



involve sophisticated and elaborate tax planning designed to minimize the overall tax burden on the corporate group resulting from the impact of U.S. and foreign tax laws. However, in many cases, especially where U.S. companies are just beginning to venture forth into the international arena or where the size of the transaction does not justify significant professional expense, such elaborate planning is absent.

Although a detailed discussion of the tax issues affecting international loans is beyond the scope of this article, the following paragraphs discuss two issues which frequently arise in international loans, and which have a direct bearing upon the loan structure.

While most tax issues, including those discussed below, are generally seen as “borrower issues,” it is important that these issues be addressed in the structuring phase. If the loan structure triggers additional taxes for the borrower or limits the borrower’s ability to obtain key deductions, this may change the underlying economics of the transaction and force the borrower to reexamine the transaction. As such, tax issues could have a negative effect on both the lender and the borrower if they are not addressed until later in the transaction.

► *Debt-to-equity ratios:* Many international loans are structured as loans to a U.S. parent corporation, which then downstreams the loan proceeds to its non-U.S. subsidiaries by means of equity contributions or intercompany loans. In fact, for those lenders who do not wish to make loans in foreign currencies directly to their non-U.S. subsidiaries, this is often the only realistic approach.

In such a structure, the U.S. borrower often seeks to downstream the loan proceeds as intercompany loans to its subsidiaries, so that repayments to the parent can be partially in the form of interest payments which are deductible by the subsidiaries. The problem with this approach is that many countries restrict the ability of a domestic company to deduct interest on loans from its nondomestic parent. These restrictions may also apply to loans to the subsidiary made by an unrelated third party, but guaranteed by the nondomestic parent. The rationale for these restrictions is that, because the interest income on such an intercompany loan is taxed in the parent’s domicile, the interest deduction in the subsidiary’s domicile without a corresponding increase in income results in a reduction of that country’s tax base. Therefore, countries often permit such interest deductions only on intercompany loans that are truly loans and not disguised equity.

In making this determination, an important factor generally will be whether the subsidiary is adequately capitalized, which in turn depends in part on whether the subsidiary’s debt-to-equity ratio does not exceed a maximum ratio prescribed by the subsidiary’s country. Some countries use an “objective” test, in which this ratio plays a

dominant role, and other countries, such as England, employ a “subjective” test, in which the ratio is only one of several factors to be considered.

The maximum ratios vary from country to country. For example, currently the ratio is 1.5:1 in France and 3:1 in Canada, Spain and Germany (although the ratio in Germany is increased to 9:1 for loans by holding companies with at least two operating subsidiaries).

► *Section 956 of the Internal Revenue Code:* One of the most frequently encountered tax issues in international asset-based lending is that posed by Section 956 of the Internal Revenue Code. That section provides, in essence, that when the assets of the non-U.S. subsidiary of a U.S. parent corporation are used to secure a loan made to the parent (such as by a guaranty given by the subsidiary, a lien on the subsidiary’s assets or a pledge of the shares of the subsidiary) that event is deemed to be a dividend by the subsidiary to the parent to the extent of the subsidiary’s untaxed earnings. This “deemed dividend” is subject to taxation in the United States. A discussion of how Section 956 accomplishes this result is set forth in the footnote to this sentence.<sup>22</sup>

An exception is generally thought to be available for a pledge of less than two-thirds of the subsidiary’s shares, which is why one often sees international loan structures involving pledges of 65 percent of a non-U.S. subsidiary’s shares.<sup>23</sup> Unfortunately, this type of pledge may not provide the lender with meaningful leverage in the event the pledge is enforced.

The amount of the deemed dividend is basically the amount of the “unpaid principal amount” of the loan made to the U.S. parent, to the extent such amount does not exceed the non-U.S. subsidiary’s undistributed earnings (or the portion thereof attributable to the parent if the subsidiary is not wholly owned).<sup>24</sup> If a non-U.S. subsidiary pledges its assets to secure the repayment of its U.S. parent’s obligation, but does not otherwise guaranty payment of the obligation, it is not clear whether the amount of the deemed dividend is limited to the value of the assets being pledged if such value is less than the unpaid principal amount of the loan made to the U.S. parent. Section 956 and the applicable regulations suggest that the amount of the dividend should be based on the outstanding amount of the loan regardless of the value of the assets pledged by the subsidiary.<sup>25</sup>

There is also uncertainty in situations where there are several non-U.S. subsidiaries granting credit support for the same loan. It is unclear whether the entire unpaid principal amount of the loan is used to determine the amount of the deemed dividend made by each non-U.S. subsidiary providing the credit support, or whether such loan amount should be allocated among the subsidiaries.

These days, if a lender proposes that the assets of the

borrower's non-U.S. subsidiary be used to secure the loan through a guaranty, lien or share pledge, it is not uncommon for borrowers and their advisors to immediately resist the request on the ground a Section 956 deemed dividend will be triggered. In fact, the use of pledges of 65 percent of a foreign subsidiary's shares has become so commonplace that some lenders will automatically include it in their proposal letters on the assumption that the borrower will object to a pledge of 100 percent of the subsidiary's shares.

However, remember that, although Section 956 may have a substantial economic impact on the borrower in some cases, in other cases the problem may only be theoretical. The subsidiary may neither have, nor anticipate, any significant earnings, or there may be tax credits which nullify or reduce the impact of the deemed dividend. Also, bear in mind that Section 956 will be triggered by *any* of the prohibited acts. Thus, if the borrower has already agreed to provide a guaranty from its foreign subsidiary or a lien on that subsidiary's assets in spite of Section 956, taking a pledge of 100 percent of the shares of the subsidiary may not make the problem any worse.

Therefore, before agreeing to give up security which might theoretically trigger a deemed dividend, a lender should ask its borrower to provide an analysis of the economic impact of the anticipated dividend. If Section 956 does pose a problem for the borrower, explore possible compromises. For example, consider taking a 65-percent pledge now, with an agreement that the remaining 35 percent is automatically pledged upon the occurrence of a specified triggering event.

### **Selected issues relating to liens**

Each country has laws concerning the creation and enforcement of liens on property located in that country, and these laws must be carefully analyzed and understood by a lender wishing to obtain liens on that property. The following paragraphs discuss a number of legal issues pertaining to liens which deserve special mention because they are so frequently encountered.

*Retention of title:* In many countries, it is customary for vendors to retain title to the goods they sell until the purchase price is paid in full. This is generally accomplished by a provision in the contract for the sale of the goods and, in some countries, can result from a unilateral declaration by the seller in a so-called "battle of forms."<sup>26</sup> The provision goes by various names: A

"Romalpa" clause in England (so named because of a case in which the clause was at issue<sup>27</sup>), a *r serve de propri t * in France, *Eigenstummvorbehalt* in Germany, and often just ROT.

In some countries, depending upon how the clause is drafted, the goods may secure only the purchase price for those specific goods, or for the outstanding unpaid purchase price of *all* goods sold by the vendor to that buyer. This type of clause is sometimes referred to as an "extended" ROT clause (or in the U.K., an "all moneys" Romalpa clause). In Germany, a vendor may expand its rights under the retention of title clause to secure debts not only owing by the buyer but also owing by affiliates of the buyer.<sup>28</sup>

Although retention of title rights generally are extinguished when the goods lose their identity (as when raw materials are converted into finished goods or goods are commingled with other goods), local law should be consulted to determine precisely when such rights are extinguished, and to verify that the rights of the vendor do not continue in the accounts receivable or other proceeds arising from sale of the goods.<sup>29</sup>

Obviously, ROT clauses have serious implications for asset-based lenders. An ROT clause's presence may mean that an unpaid vendor can assert a superior claim to goods which it sold to the borrower (and possibly proceeds), thereby eroding the lender's collateral base. Additionally, because these clauses do not result in the creation of a lien, but rather result in title remaining with the vendor, a lender will not be able to detect ROT clauses by means of a lien search.

If the lender has sufficient time to identify vendors with ROT rights, the lender may be able to negotiate with those vendors and obtain waivers. If waivers are not obtainable, the lender can address the issue in another way, such as by creating an appropriate reserve. At a minimum, lenders must be careful to determine, at the due diligence



EACH COUNTRY HAS LAWS  
CONCERNING THE CREATION  
AND ENFORCEMENT OF LIENS  
ON PROPERTY LOCATED  
IN THAT COUNTRY ...



phase, whether a retention of title risk exists.

*Prohibitions on assignments of accounts:* In many countries, it is not uncommon for purchasers of goods to include prohibitions on assignment in the documentation evidencing their accounts. Under U.S. law, such a prohibition would not limit a lender's security interest because the Uniform Commercial Code renders the prohibition ineffective.<sup>30</sup> However, that is not the case under the laws of many countries.

Some countries have attempted to deal with the issue. For example, Germany has enacted a law providing that, in a commercial transaction, a

transfer of an account receivable is effective notwithstanding a prohibition against assignment.<sup>31</sup> However, this law represents only a partial solution to the problem, in that it also gives the account debtor the option to discharge the account by making payment directly to the borrower.<sup>32</sup>

This issue may also be relevant to a lender who makes loans to a U.S. borrower secured by accounts receivable generated from sales to customers in other countries. Although a prohibition against assignment of these accounts would undoubtedly be ineffective if U.S. law were deemed to apply, the result is less clear if the underlying purchase contract between the borrower and its customer is governed by the laws of a country in which such a prohibition is enforceable (especially if the lender attempts to enforce the account directly against the customer by a lawsuit in the other country). This issue becomes academic in a traditional domestic asset-based loan where the foreign receivables are generally backed by letters of credit.

The methods by which a lender may be able to structure around this issue are similar to those discussed above with respect to retention of title. Perhaps the account debtor can be persuaded to waive the prohibition. Alternatively, an appropriate reserve may be created. At worst, the accounts may be classified as ineligible. At a minimum, a lender should conduct due diligence to determine whether such prohibitions exist.

*Priority of liens:* For the lender, a large part of documenting any security interest is knowing where you stand in line *vis-à-vis* the collateral: Who is ahead of you now, and who can unexpectedly jump ahead of you later.

In the United States, the most important tool for making this analysis is the filing system established by the

Uniform Commercial Code. However, in many countries there is no filing or registration system for certain types of personal property. As a result, there is no way to conduct a search to identify conflicting liens. A case in point is Germany, where liens on accounts receivable, inventory and equipment are not filed or registered. In those cases, the lender must be content to rely on representations of the borrower as to the absence of conflicting liens. For many U.S. asset-based lenders, this continues to be the most unnerving feature of international lending.

Some countries have filing systems that do not provide complete certainty for a lender. For example, in England, security interests in accounts receivable, inventory and equipment are typically evidenced by a document known as a "fixed and floating charge," which is registered with the Registrar of Companies. However, there is a 21-day grace period for registering. Because of this grace period, it is possible that a properly registered charge could be primed by another charge that pre-dates it and is registered subsequently, but within the grace period.

Moreover, the laws of many countries provide that even a "first priority lien" will be junior to certain categories of claims, often for taxes and employee-related obligations. For example, in England, under a typical fixed and floating charge, the floating charge (which is essentially a lien on property that the borrower has the right to freely dispose of without the lender's consent, such as inventory which may be sold in the ordinary course of the borrower's business, or accounts receivable if the lender does not exercise dominion over the proceeds) will be subject to preferential claims for certain taxes and employee-related claims.<sup>33</sup> On the other hand, the fixed charge (which is a lien on property that the borrower may not dispose of without the lender's consent) will not be subject to preferential claims.

An approach that lenders sometimes use in response to these and other issues affecting the perfection or priority of liens on accounts receivable, especially where the borrower has numerous non-U.S. subsidiaries, is to propose that the subsidiaries establish a "finance subsidiary" located in a jurisdiction having more advantageous laws and procedures concerning the perfection of liens on receivables and transfer their receivables to this new subsidiary as they are generated.

*Documenting liens on non-U.S. collateral:* An important issue which arises in an international loan is the choice of law that will govern the loan documents, as well as the proper form of those documents. Although it is generally appropriate for a lender to require that certain documents, such as the credit agreement, be U.S. forms governed by U.S. law, certain documents, such as those which evidence liens on non-U.S. collateral, should generally be governed by the laws of that other country, and should be in a form customarily used in that country.

There are a number of reasons for this. First, a



**One reason that U.S. forms are sometimes used is that foreign collateral is often viewed purely as additional collateral, and is taken “for what it’s worth.”**

properly drafted local form will often contain waivers and other provisions dealing specifically with important aspects of local law.

Second, in the event that the lender is ever required to enforce the document in a local court, it is generally preferable that the document be in a form, and also in a language, with which the judge is familiar.

Third, in some situations there can be serious questions as to the effectiveness of certain types of security documents which do not follow the prescribed local form.

In the author’s view, this rule of practice should extend to pledges of the shares of a non-U.S. company, even where the pledgor is a U.S. company. These pledges present an interesting case, because the shares possess attributes of two countries: The shares are created under the laws of the foreign country, and are therefore creatures of that country’s law, but at the same time represent property of the U.S. company. Nevertheless, the appropriate practice generally is to use the form of pledge agreement prescribed by the country in which the issuer of the shares is domiciled.<sup>34</sup>

Using a U.S. form of pledge agreement might work in certain situations, but can also lead to complex and dangerous conflict of law issues which could threaten the enforceability or priority of the pledge, especially in countries where the pledge must be registered, or a tax must be paid in connection with the pledge. It may be difficult or impossible to enforce the pledge in a court located in the country in which the issuer of the pledged shares is domiciled. As an alternative, the lender could seek to enforce its U.S. pledge agreement in the United States (presumably through a non-judicial public or private sale under Section 9-504 of the Uniform Commercial Code), thereby arguably divesting the pledgor of its interest in the shares, and then seek recognition or enforcement of that result in the foreign country. However, a court in the foreign country could refuse to recognize the procedure followed by the lender, and might even refuse to recognize the pledge at all. Why take the chance?

One reason that U.S. forms are sometimes used is that foreign collateral is often viewed purely as additional collateral, and is taken “for what it’s worth.” As a result, there is a desire to document these liens in the least

expensive way. This approach not only involves using U.S. forms, but often involves no attempt to investigate local legal requirements.

One problem with this approach is that this collateral may become extremely important if the loan goes into default. Hoping that the security documents will be enforceable, the lender will then instruct its lawyers to evaluate the documents, only to discover that they may not be enforceable because they are not in the correct local form or not properly registered, or that a crucial tax has not been paid. Ironically, the expense incurred in evaluating the documents in this manner and sifting through the conflicts of law issues, often only to conclude that the documents may be useless, can exceed the cost of documenting the security properly in the first place. Additionally, the lender is forced to waste precious time.

A second problem is that as loan officers change over the years, a new officer administering the loan may make a credit decision under the possibly erroneous assumption that the lender has valid liens on foreign collateral.

A third problem is that the failure to comply with local tax or other legal requirements could result in the imposition of fines and other penalties on various parties to the transaction. It is also possible that using this approach could inadvertently impair the enforceability of the loan indebtedness secured by such collateral. For example, under German law, if a loan to a *GmbH* is secured in whole or in part by a pledge of the shares of the *GmbH*, and the pledge agreement fails to contain appropriate limitations with respect to dividends or voting rights, it is possible that the loan itself could be viewed as an “equity-replacing shareholder loan,” with the result that the loan could, in a bankruptcy of the *GmbH*, be treated as share capital subordinate to all other creditors.<sup>35</sup>

A far preferable approach would be to insist upon proper documentation of the liens initially, but to monitor the documentation process closely to make certain that the documentation cost remains reasonable.

### **Conclusion**

Eight years ago, at the conclusion of my previous article, I wrote:

“One of the remarkable qualities of the asset-based

lending industry is its capacity to respond, with creativity and determination, to an ever-changing business environment. The globalization of American middle-market business that we are now witnessing is testing that capacity once again. I have no doubt that our industry will respond well to this challenge.”

It is clear that our industry has indeed responded well to that challenge, and will continue to do so.

It is intriguing to speculate about the future of international asset-based lending. I assume we will witness many exciting innovations and trends, such as increased harmonization of lending laws, the establishment of centralized international filing systems and a proliferation of co-lending projects by U.S. and foreign banks, all facilitated by advanced forms of communication. Ultimately, international asset-based lending may become almost as natural as domestic lending. Whatever happens, it is clear that U.S. asset-based lenders will play a prominent and vital role in the global economy during the next eight years and beyond. ▲

*The author gratefully acknowledges the assistance of Jonathan M. Cooper, Ellen C. Matheussen and Mirari M. Barriola of Goldberg, Kohn, Bell, Black, Rosenbloom & Moritz, Ltd. in the preparation of this article.*

## ENDNOTES

- (1) Richard M. Kohn, *Reflections on International Asset-Based Lending*, 47 THE SECURED LENDER 8 (1991).
- (2) United Nations Commission on International Trade Law.
- (3) International Institute for the Unification of Private Law.
- (4) In this article, the term “domestic company,” when used with reference to a particular country, refers to a company domiciled in that country.
- (5) LOIS COORDONÉES SUR LES SOCIÉTÉS COMMERCIALES/ GECOORDINEERDE WETTEN OP DE HANDELS-VENNOOTSCHAPPEN [Belgian Coordinated Company Law], art. 52 ter, 60, 62, 107, 128 ter, 206, 158, 1° (Belg.).
- (6) Second Council Directive 77/91/EEC, art. 23, Dec. 13, 1976.
- (7) The legislative history of this Directive offers little guidance as to the impetus for the Directive. In fact, the two proposals submitted to the E.C. Council of Ministers by the European Commission do not contain, or even reference, any provision on financial assistance. However, the preamble to the Directive suggests that one goal was to preserve the capital of domestic companies by restricting distributions to shareholders at the expense of the compa-

nies’ creditors. The preamble provides, in part: “Whereas Community provisions should be adopted for maintaining the capital, which constitutes the creditor’s security, in particular by prohibiting any reduction thereof by distribution to shareholders where the latter are not entitled to it and by imposing limits on the company’s rights to acquire its own shares.”

- (8) Companies Act, 1985, §155 et seq. (Eng.).
- (9) GESETZ BETREFFEND DIE AKTIENGESELLSCHAFT [Stock Corporation Act], §71(a) (F.R.G.).
- (10) M. Verplancke, *Commentaar bij de Venootschapswet*, Kluwer (losbladig), at 67-68 (1999).
- (11) *See id.* at 67 et seq.
- (12) Gerald Shea and Peter Shabecoff, *Guarantees and Security in European M&A*, 14 THE INT’L FIN. L. REV. 13, 15 (1995).
- (13) *See id.* at 13.
- (14) Roger McCormick, *International Financing of US Takeovers*, 671 PLI/CORP. 491 (1990).
- (15) BGH, Urteil vom 19. März 1998 (IX ZR 22/97, Kammergericht) (F.R.G.).
- (16) *See, e.g.*, Business Corporations Act Revised Statutes of Ontario, 1990, ch. B.16, §20; *see also*, Canada Business Corporations Act. R.S., 1985, c. C-44, s. 1; 1994, c. 24, s. 1(F) §44.
- (17) Fourth Council Directive 78/660/EEC, July 25, 1978; Seventh Council Directive 83/349/EEC, June 13, 1983; and Eighth Council Directive 84/253/EEC, Apr. 10, 1984.
- (18) Green Paper on *The Role, The Position and The Liability of the Statutory Auditor Within the European Union* [hereinafter Green Paper] §2.5 July 1996 (Brussels).
- (19) *See, e.g., id.* at §6; *see also*, Fédération des Experts Comptables Européens, *The Role, Position and Liability of the Statutory Auditor in the European Union* [hereinafter Fédération Report] Jan. 1996 (Brussels).
- (20) Green Paper, *supra* note 18, at §3.30 et seq. Under French law, for example, a statutory auditor can face criminal penalties for failing to report certain breaches of law by the company.
- (21) Green Paper, *supra* note 18, at §3.14 et seq.; *see also*, Fédération Report, *supra* note 19, at §2.4.
- (22) Section 956 and various related sections of the Internal Revenue Code were enacted to limit a U.S. shareholder’s ability to defer paying taxes on the earnings of its controlled foreign company (“CFCs”) to the extent the U.S. shareholder presently benefits from such earnings. As a result of these sections, a U.S. shareholder may be taxed on certain of its CFC’s earnings before such earnings are distributed to the U.S. shareholder.

There are a number of circumstances that can result in the imposition of such taxation. One such circumstance focuses on the investment by a CFC of its earnings in U.S. property. Under Section 956, to the extent that a CFC invests its earnings in certain types of property located (or deemed located) in the U.S., the amount of such earnings may be taxed to the U.S. shareholder as if such earnings were distributed to the U.S. shareholder. *See* I.R.C. §§956 and 951(a)(1)(B).

The Internal Revenue Code views the granting of certain types of credit support by a CFC to a lender in connection with a loan being made to the CFC’s U.S. shareholder as an investment by the CFC in U.S. property (that is, the loan being made to its U.S. shareholder). Under Section 956(d), a CFC is considered to hold an obligation of a U.S. shareholder if the CFC is a “pledgor or guarantor of such

*Richard M. Kohn is associate general counsel of CFA. He is head of the Commercial Finance Group at Goldberg, Kohn, Black, Rosenbloom & Moritz, Ltd., Chicago, IL. He is also a founding member of the CFA Education Foundation.*



obligation.” Accordingly, the CFC’s earnings could be subject to tax under Section 956 to the extent of the value of such credit support.

The rationale for this approach is that if a U.S. shareholder is able to utilize the value inherent in its CFC to obtain a loan (by the use of a guaranty or other credit support granted by the CFC), the U.S. shareholder is benefiting from its CFC’s earnings before such earnings are distributed to the U.S. shareholder. Under this rationale, a pledge by a U.S. shareholder of its shares in its CFC should in theory not trigger Section 956 taxation (since the credit support is being given by the U.S. shareholder and not by the CFC). Nonetheless, the regulations expressly provide that a CFC will be considered a guarantor of a loan made to its U.S. shareholder if, among other things, at least 66 2/3% of the total combined voting power of such CFC is pledged. *See* Regs. §1.956-2(c)(2).

When a U.S. shareholder serves as a mere conduit for a loan to a CFC (that is, no proceeds of the loan are retained by the U.S. shareholder, but are instead downstreamed to the CFC), Section 956, at least in theory, should not apply. Section 1.956-2(c)(4) of the regulations provides a very specific example of a type of conduit financing that would not result in taxation under Section 956. A detailed discussion of conduit financing is beyond the scope of this article.

- (23) *See* Regs. §1.956-2(c)(2).
- (24) *See* Regs. §1.956-1(e)(2).
- (25) *See* Regs. §1.956-2(c).
- (26) *See, e.g.* BÜRGERLICHES GESETZBUCH [German Civil Code], §455 (F.R.G.).
- (27) Aluminium Industrie Vaassen B.V. v. Romalpa Aluminium Ltd., 1 W.L.R. 676 (1976), which involved such a clause.
- (28) *See* P. Bulow, *Recht der Kreditsicherheiten*, at 145 et seq. (1993).
- (29) The possibility that the rights of the vendor extend to proceeds was suggested in Romalpa Aluminum Ltd. 1 W.L.R. 676; however, this suggestion has been rejected in a number of subsequent United Kingdom cases. *See, e.g.* *Modelboard Ltd. v. Outer Box Ltd.*, BCC 945 (1992).
- (30) Uniform Commercial Code §9-318(4). Although this subsection literally covers only assignments, it is generally thought to cover security interests as well. This ambiguity has been eliminated by the proposed revisions to Article 9 which are currently being introduced to state legislatures.
- (31) HANDELSGESETZBUCH [German Commercial Code], §354 (F.R.G.).
- (32) *Id.*
- (33) Insolvency Act of 1986, §386 (Eng.).
- (34) Hans-Michael Giesen and Tim Oliver Brandt, *International Finance Transactions – the Pledge of Shares in a German Limited Liability Company*, 31 INT’L. LAW. 1047, 1050 (1997).
- (35) *Id.* at 1063-1066.