The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 20, No. 10 October 2012

The Many Forms Of Foreign Trade

*The Editor interviews **R. Andrew Richards**, Partner in the Corporate Securities and Financial Institutions practice of McCarter & English, LLP.*

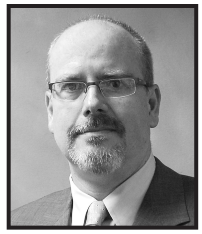
Editor: Please describe your practice areas, particularly those in which you concentrate most heavily.

Richards: I am a member of the firm's Corporate and Financial Institutions practice group and have an extensive background in structuring, negotiating and documenting financial transactions, including senior and mezzanine credit facilities, asset-based and cash flow credit facilities and acquisition financing. On the lender's side my clients include traditional banks, finance companies, insurance companies, private equity funds and other financial institutions in their various roles as first and second lien lenders, mezzanine debt holders, and as lenders or agents. I also represent institutional clients in work-outs and restructurings. Additionally, on an ongoing basis I counsel clients regarding venture capital investments, mergers and acquisitions, joint ventures, international trade and other commercial and contractual matters, most often for middle market clients.

Among the more interesting aspects of my practice is the transactional work I do for a prominent social investment fund that makes both loans and equity investments at a reduced rate of return, but otherwise on an arm's-length basis, to promote economic development and socially beneficial causes, both domestically and internationally. My involvement in microfinance in Africa, which I will discuss later, has been both an inspiration and resource for this work.

Editor: Please describe the types of clients you have outside the U.S. I understand they come from Europe, the Middle East and India. What types of financing does their work involve?

Richards: The economic slowdown has made many foreign companies reluctant to open representative offices in the U.S. and hire executive, sales and operational employees. Instead, they are looking for cheaper and lower-risk alternatives, despite those options being less profitable. So the alternatives for a foreign company are the following: entering into joint venture agreements with U.S. companies, entering into distribution agreements, and licensing its intellectual property and know-how to U.S. manufacturers. These options can generally be self-financed.



R. Andrew Richards

Larger foreign entities are usually able to obtain credit facilities like any other company. Among the issues that arise in these financings are how to isolate the collateral of the borrowing U.S. operation from the assets of the foreign parent and subsidiaries that may be pledged to a foreign lender, and how to prevent guaranties issued to the U.S. or foreign lender from breaching negative pledges to the other lender.

Editor: Some of the areas that you deal with include the rarer areas of finance such as New Markets Tax Credit leverage loans, dividend recaps and microfinance. Would you describe what each of these areas entails?

Richards: I have handled a number of loan transactions where the collateral is of a type that is outside the customary reach of Article 9 of the Uniform Commercial Code. These include loans secured by intellectual property, marine vessels, airplanes and motor vehicle fleets. Unlocking the value of these assets is extremely important as intellectual property is increasingly a larger component of balance sheet assets and for companies that hold a large percentage of non-cash-generating assets. From a legal perspective, these transactions are challenging because the creation of liens or their perfection is governed by another statute rather than the more commonly understood Article 9.

Another form of loan transaction involving esoteric collateral where I have represented both lenders and borrowers is the capital call lending facility. These are bridge facilities supported by a security interest in the limited partners' unfunded capital commitments. Since the collateral is essentially the right to exercise a contractual right, a careful due diligence review of the governing limited partnership agreement is essential. Among the critical issues to confirm are that the fund is authorized to borrow, that it may pledge and grant a security interest in the contractual right to make capital calls upon limited partners and that there exists an unconditional obligation on the part of limited partners to fund when a capital call has been duly issued. Documentation of these facilities should take practical considerations into account as well, such as requiring a power of attorney from the general partner to support the lender's ability to exercise rights under the limited partnership agreement and obtaining an acknowledgment from the limited partners of their obligation to fund upon receipt of a capital call from the lender following an event of default.

As a result of the current economic climate we have seen an increase in dividend recap loans. When the economy deteriorated and credit markets tightened, private equity funds and other investors were forced to make larger equity investments to finance acquisitions. As the credit markets have loosened and those investments show solid earnings, dividend recap loans are an option that allows investors to finance dividend payments to recoup their investments rather than selling their equity.

Together with skilled tax counsel I have structured and documented leveraged loans under the complicated federal New Markets Tax Credit program. The program encourages investments in real estate and other business ventures located in low-income communities by granting a tax credit to participating investors against their income tax liabilities. The equity investor's contribution of roughly 25 percent of a development project can be leveraged with a loan, the sum of which under applicable federal regulations then generates up to a 39 percent tax credit. The discounted tax credits are then sold to the equity investor. These loans are especially complicated, given the federal regulation, the multiple layers of entities involved and restrictions on the leverage lender's ability to collateralize the loan.

Editor: Please tell our readers about your two years of work in Cameroon.

Please email the interviewee at arichards@mccarter.com with questions about this interview.

Richards: I took a sabbatical from my legal career and for two years lived in rural Cameroon, in central Africa, where I was an advisor to a network of credit unions and the country's nascent banking system. My work involved advising bank management on best practices and procedures, improving underwriting standards and the functions of credit committees, and developing sound loan portfolio management. The economy of the region where I lived was agrarian, and agricultural production revolved around tropical commodities such as coffee, cocoa, rubber and tropical fruits, which were then sold in bulk to Western companies. As in any such economy, the countryside producers were very poor. In addition to the work with the credit unions, I gave advice on many projects to add value in-country to the commodity crops before their export. Although I didn't function as a lawyer, I drew on my skills as a counselor and other lawyering skills such as the ability to analyze problems and craft solutions. The work was challenging but overall very rewarding. I learned firsthand about and participated in the microfinance revolution that is transforming the developing world. And I became a better lawyer as a result of working under difficult conditions, functioning for two years in French and observing the world from an uncommon perspective.

Editor: Please give a brief snapshot of how microfinance has spread from Bangladesh around the world.

Richards: Microfinance, the concept of making loans as small as $20 to an entrepreneur in a developing country so he or she can build a business, has grown exponentially over the past 15 to 20 years. While it sounds innovative and exotic, in practice in its simplest form it involves mobilizing community savings and then using that funding source to make creditworthy loans. So it is very much akin to a credit union or savings and loan, and similar to the U.S. banking system of 75 years ago. A key feature of microfinance is finding creative ways to ensure repayment of loans in places where credit checks, title to collateral and lien creation and enforcement mechanisms are poor or non-existent. This is done in a number of ways, including accepting non-traditional collateral and fostering community involvement in loan repayment. Muhammad Yunus of Bangladesh is credited as a major pioneer of the movement. Although it has its critics, most observers would say the movement has been a huge success and it has certainly been transformative. There are hundreds of millions of people worldwide involved with their local microfinance institutions, which have heavily penetrated Latin America, Asia and much of Africa. Most microfinance institutions are locally run, often with little oversight, and are financially fragile. So the next stage of the movement, in my view, should be to integrate the microfinance networks more into national economies, provide the supporting services of a central bank and an FDIC-type institution, and developing sound oversight.

There has been a lot of debate about whether microfinance can be an effective economic development tool in the U.S. Based on my own involvement, I don't think the developing world model would be effective here. The problem abroad is an inability to access capital, whereas most Americans can obtain some form of seed capital, even if from a credit card. Job training and financial education need to play significant roles in domestic grassroots entrepreneurialism of at-risk people.

After my experience in Africa, I have been fortunate to have institutional clients who are involved with the overall funding of microfinance programs. So, I have been involved in microfinance at the grassroots level and at a macro level.

Editor: Besides the customary forms of use of letters of credit and bills of lading, are you seeing more international trades being done on open account today? What instrumentality is being used to protect collateral?

Richards: With my own clients, I've seen the value of the Export-Import Bank of the United States ("Ex-Im Bank"), our federal export credit agency. It was chartered about 75 years ago to address the particular risks and difficulties faced by exporters, which include political risks such as war, expropriation, confiscatory taxation and inconvertible currency, and commercial risks such as bankruptcy and the problem of long-distance contractual enforcement. On top of this, foreign buyers in developing countries often don't have liquid means to pay for goods they are importing because of their underdeveloped banking systems and capital markets. The result is that U.S. lenders are often reluctant to finance exports and will even curtail working capital lines of credit to finance the manufacturing process out of concern for the risks to cash flow that will cover repayment. The transactional costs of letter of credit facilities to address these issues is especially burdensome on sales by smaller manufacturers.

Ex-Im Bank has a number of core financial services intended for small businesses in areas where the commercial financial institutions are unable to provide financing at rates they can afford. These include export credit insurance, working capital facility guarantees, and guarantees and direct loans. Also, Ex-Im Bank has strategic mandates from Congress to support areas such as renewable energy and African trade. Ex-Im Bank is relatively user-friendly because of its "delegated authority program" through which a U.S. bank can issue Ex-Im Bank guaranties without prior approval and without the exporter needing to interface with Ex-Im Bank itself.

Ex-Im Bank credit insurance covers nonpayment from commercial and political risks. With such insurance, an exporter's receivables may be more likely to be financed by a local bank. Additionally, it enables the exporter to offer open-account terms. With such foreign customer financing, the foreign customer can avoid looking for financing to cover an advance cash payment or the cost of a letter of credit.

Ex-Im Bank facilitates working capital lines of credit during the manufacturing process by issuing a guarantee on behalf of the exporter in favor of a local bank, covering 75 percent of inventory, whether raw materials, work-in-progress or finished goods, and 90 percent of accounts receivable. Ex-Im Bank also makes longer-term fixed-rate loans to both the U.S. exporter and its foreign customers to cover contract costs.

Editor: How do you counsel clients as regards their assuring that their supply chains will be protected? What lessons did we learn from the Japanese tsunami and the floods in Thailand?

Richards: Companies know that they should not simply focus on financial controls but also periodically review their operational controls and have a solid business continuity plan in place to deal with the issues affecting their locale. But the Asian disasters that you cite taught that contingency planning also needs to take into account the ripple effect caused by disasters that foreign businesses confront on other continents. From a contractual perspective, one would want force majeure clauses to be flexible enough to permit a rapid shift to other suppliers, at least in the short term. The all-too-common 30-day holding period before the contract can be terminated or performance suspended should be reassessed for these kinds of situations.

Editor: To what extent do you work with clients in effecting training programs for their employees so that they are apprised of all the federal rules regarding economic sanctions on trade?

Richards: Like other big law firms, we have regulatory experts who counsel clients involved in foreign trade, whether import or export. There are a host of statutory and regulatory schemes that are implicated, such as the Patriot Act, the Foreign Corrupt Practices Act (FCPA) and the International Trafficking in Arms Regulations (ITAR). We do presentations to clients as to their obligations under these laws and have documentation and content for implementing written compliance policies and manuals. Various cases in recent years have shown the high cost of non-compliance and remind us that an ounce of prevention is worth a pound of cure.