

Issues for asset-based lending funds – protecting your collateral in structured cross-border commodity finance



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Issues for asset-based lending funds – protecting your collateral in structured cross-border commodity finance

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Asset-based lending has increased dramatically in the past few years, both within the US and in the emerging markets. This growth can be attributed to the growth of the economies in the emerging markets and the demand for commodities and natural resources.

As the market has increased in size, the participation of banks seems to have diminished, or at least slowed in growth, while the participation of hedge funds has blossomed virtually overnight. Both consolidation as well as regulatory requirements for banks coming out of the Basel II accords, have contributed to banks' diminished participation. Basel II is the capital accord finalised by the Basel Committee on Banking Supervision at the Bank of International Settlements at the end of June 2004, which established a new common international standard and method for calculating the capital requirements or capital adequacy of banks, replacing the prior standard adopted by Basel I.

Lower returns in the equity markets in recent years have brought the returns generated by asset-based lending, once considered well below what hedge fund investors would expect, more in line with investors' new expectations. With returns now aligned with investors' expectations, asset-based lending funds have become a popular and much sought after strategy by institutional investors seeking strategies with low correlation to that of long-short equity, along with relatively stable and consistent returns of between 80-100 basis points per month, without the use of significant leverage.

Hedge funds not only are sourcing loans themselves, but are a huge player in the secondary market as the originating banks find them easier to deal with than some of their historical buyers – bond funds and insurance companies – since the hedge funds are solely focused on this market and more comfortable with the loan documentation.

The emerging markets of Latin America and Asia have provided many of the opportunities for funds pursuing asset-based lending strategies. The funds have recognised that the emerging markets do not necessarily imply higher risk. In fact, risk-adjusted returns are often higher than in the US, since rates in the emerging economies can be higher due to smaller pools of liquidity, and borrowers are ready to provide attractive collateral packages since they otherwise lack sufficient access to capital.

For many of the hedge funds focusing on asset-based lending, the management team is located in either the United States or Europe. Therefore, the management team and its US or European-based legal counsel will be heavily dependent on local counsel in the foreign jurisdictions where the loans are being made in order to document the

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transaction and perfect their liens on collateral. The collateral package and accompanying documentation is especially critical with the cross-border financing of commodities since these transactions involve a number of potentially significant risks, including the following:

- **Market.** The market price for the commodity may fluctuate, along with the cost of storage and transportation.
- **Breach/Non-performance.** The borrower may breach its contracts, or may become insolvent or may otherwise be unable to perform, due to force majeure or other reasons.
- **Casualty.** The commodity may be damaged, destroyed, lost or stolen.
- **Political.** The local government may expropriate the commodity, impose prohibitive regulations or taxes, or restrict or prohibit the export of the commodity or the transfer of funds outside of the country.
- **Legal enforceability.** Your contractual rights, including any rights in collateral, may be unenforceable under local law.

With the exception of legal enforceability, these risks are largely outside of the lender's control, although they can usually be mitigated. For example, hedging arrangements can be used to reduce market risk and insurance coverage can be obtained for non-performance, casualty and political risk. The risk that an agreement may not be legally unenforceable, on the other hand, is controllable, and for that reason is generally not insurable. Indeed, insurance policies typically specifically exclude losses caused by the failure of underlying agreements to be enforceable under local law.

The rights and interests of the parties in goods such as commodities will necessarily be governed by the local law of the jurisdiction where the commodities are physically located, notwithstanding the fact that the underlying documentation may be governed by English or New York law, or the law of some other jurisdiction with which the party providing the financing has a relationship. The parties cannot contract around this by agreeing otherwise.

Consequently, when structuring a commodities financing where you expect to have an interest in the commodity as collateral, it is important to fully understand applicable local laws. Particular attention should be paid to laws governing the sale of goods, secured transactions, insolvency, export controls and warehouses, but laws relating to banking and credit, currency/exchange controls, taxation and dispute resolution, are also relevant as they would be in any cross-border loan.

Following is a list of questions for foreign counsel which the lender or their principal transaction counsel may find helpful in conducting legal due diligence for a cross-border commodity financing. This list is not exhaustive by any means, and should not be relied upon to uncover everything that you need to know. Indeed, each jurisdiction has unique issues and anyone who has conducted a due diligence exercise of any scope knows that one question invariably leads to another, which makes the preparation of an exhaustive list impracticable. The list is best used simply as a reminder of the various areas of enquiry that you will need to pursue.

Questions for foreign counsel

<i>Secured transactions</i>	
<ul style="list-style-type: none"> • How are security interests in goods such as the commodity perfected? 	<p>Generally speaking, perfection is accomplished either by filing or registering the security interest or by taking possession of the collateral. In jurisdictions where there is no filing or registration system, you could take ‘constructive possession’ of a commodity that is stored in a warehouse by having the borrower transfer a warehouse receipt to you. Note, however, that unless the warehouse receipt is negotiable (see ‘Warehouse receipts’ below), transfer of the receipt will not, in and of itself, be sufficient to perfect your interest. You will want the warehouse operator to either issue a new receipt directly to you, or explicitly acknowledge, in writing, that the collateral is now being held on your behalf.</p>
<ul style="list-style-type: none"> • Is a public filing, recording or registration required in order to perfect non-possessory security interests in goods such as the commodity? 	<p>Under New York law, if the law of the jurisdiction where the borrower is located has no public filing requirement with regard to non-possessory security interests, the borrower will be deemed to be located in Washington, DC. Consequently, with certain limited exceptions, the perfection of a non-possessory security interest in goods such as commodities would be determined under Washington, DC law, while the effect of perfection or non-perfection and the priority of such security interest would be determined under the local law of the jurisdiction where the commodities are located.</p>
<ul style="list-style-type: none"> • Does the legal status of the borrower have any effect on my security interest (eg, individual, partnership, limited liability company, etc.)? 	<p>In some jurisdictions, certain legal entities cannot enter into secured transactions. In any event, the legal status of the borrower may affect your rights as a secured party.</p>
<ul style="list-style-type: none"> • Does it matter for purposes of obtaining a perfected security interest whether the commodity is fungible and/or commingled? 	<p>Commingling of fungible commodities can cause problems with title and security interests in some jurisdictions.</p>
<ul style="list-style-type: none"> • Are floating liens permitted? Liens on after-acquired property? 	<p>Floating liens, such as liens on all of the borrower’s property from time-to-time are not possible in many jurisdictions. The same is true of liens on property that is acquired by the borrower after the security interest is granted.</p>

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<ul style="list-style-type: none"> How do I enforce my lien? Can I foreclose and repossess and sell collateral after a default without the intervention of the courts or other governmental entities? 	<p>Few countries permit US-style self help following a default. In most jurisdictions, it will be necessary to apply to a court to obtain permission to foreclose and repossess collateral.</p>
<p><i>Sale of goods</i></p>	
<ul style="list-style-type: none"> What are the legal requirements for an enforceable contract of sale? Are there any restrictions on the ability to contract under local law? 	<p>This will be important in cases where you either purchase the commodity yourself (as opposed to taking a pledge) or take an assignment of the buyer's rights under a purchase agreement (eg, pre-payment financing).</p>
<ul style="list-style-type: none"> When do title and risk of loss pass from the seller to the buyer under a contract of sale for goods such as the commodity? 	<p>In most jurisdictions, including the US, the parties are free to agree when title and risk of loss will pass. Absent agreement, title and risk of loss generally pass when the seller has completed its performance with respect to the delivery of the goods.</p>
<ul style="list-style-type: none"> Are title reservation agreements recognised and enforced as such once the seller has parted with possession of the sold goods? 	<p>In the US, a seller of goods under a conditional sale agreement who has parted with possession is treated as a secured creditor. Title passes to the buyer, notwithstanding the fact that the agreement provides otherwise, and the seller merely has a security interest in the sold goods. That is not the case in the UK and in most civil code countries.</p>
<p><i>Warehouses</i></p>	
<ul style="list-style-type: none"> Are warehouse receipts recognised as title documents? 	<p>If warehouse receipts are recognised as title documents under local law, transfer of the warehouse receipt itself is considered sufficient to transfer title to the stored commodity. If warehouse receipts are instead merely treated as evidence of the storage of the commodity by the warehouse operator, the transfer of the receipt alone will not be sufficient to perfect your interest. In that case, you would want the warehouse operator to either issue a new receipt in your name or acknowledge the transfer and agree to deliver the stored commodity to you.</p>
<ul style="list-style-type: none"> Are warehouse receipts transferable? Negotiable? 	<p>Warehouse receipts must be transferable in order for the borrower to transfer its rights to you. Many countries, including the US, have established systems of negotiable warehouse receipts, where receipts are freely transferable and the holder of the receipt obtains a direct claim against the stored commodity. In fact, the holder takes free of any defences the warehouse operator may have had against the original depositor or any other person. As a result, they are relatively easy to sell to third parties if you want to liquidate the collateral after a default without taking possession of it.</p>

<ul style="list-style-type: none"> Are warehouses subject to regulation? To what extent are they liable for losses while my collateral is in their custody? 	<p>An adequate system of regulation ensures that warehouses meet certain minimum standards. Regulations often contain provisions for licensing and inspection, minimum net worth requirements, insurance or bonding requirements and standards for determining the liability of the warehouse operator for losses.</p>
<ul style="list-style-type: none"> Is there an adequate system of grades and standards in place so that my collateral can be stored without my having to physically examine it? So that I can be sure that if my collateral is commingled, the quality withdrawn is the same as the quality deposited? 	<p>The warehouse operator is responsible for checking to be sure that the commodity meets minimum quality standards. The quantity and quality of the commodity received for storage is then indicated on the receipt. If you are relying on a warehouse receipt as security for your loan, you are relying to a large extent on laws regulating warehouses and on the capability and integrity of the warehouse operator.</p>
<p><i>Insolvency</i></p>	
<ul style="list-style-type: none"> How do the insolvency laws work? What recourse will I have if the debtor and/or the warehouse operator become insolvent? 	<p>These are basic questions that apply in any loan transaction, but the insolvency of a third party custodian or bailee can greatly complicate matters, which is why the warehouse operator's credit is important. Special legislation dealing with warehouses may also be important here because time is often of the essence with commodities. An expedited procedure for retrieving your commodity from a bankrupt warehouse operator could be critical.</p>
<p><i>Export controls</i></p>	
<ul style="list-style-type: none"> Are there any restrictions on the export of the commodity from the country? On my ability to export, if necessary, after foreclosure? 	<p>If special approvals are required in order to export the commodity from the country, you need to make sure that such approvals will extend to you, in the event that it becomes necessary to foreclose and take over the collateral after a default.</p>
<p><i>Taxation</i></p>	
<ul style="list-style-type: none"> Are there any taxes, customs duties or fees or other similar charges payable in connection with the sale of, or the granting of a lien on, the commodity? On the export of the commodity? 	<p>These are basic questions applicable to any cross-border loan transaction.</p>
<ul style="list-style-type: none"> Will I be deemed to be doing business in the jurisdiction, and consequently subject to local income taxation, simply by virtue of my loan or my interest in the collateral? 	<p>These are also basic questions applicable generally in cross-border loan transactions. A sale of the collateral after a default could be considered to be 'doing business' for tax purposes.</p>

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Currency controls	
<ul style="list-style-type: none"> Are there currency and or exchange controls that restrict or prohibit obtaining dollars and/or transferring them abroad? If I foreclose and sell the collateral, will I be permitted to remit the proceeds abroad? 	Whether the borrower's jurisdiction has currency controls is a basic question in loan transactions. It usually comes up in the context of the borrower's ability to make payments on the loan, but if you might sell the collateral locally after a default, you may also need approval to remit the proceeds abroad.
<ul style="list-style-type: none"> Can a local entity maintain offshore accounts into which buyers of the commodity will remit funds directly? 	If currency controls are in place, the borrower may be prohibited from maintaining accounts offshore or may need special approval to do so.
Dispute resolution	
<ul style="list-style-type: none"> Are there any limits on my ability to bring suit in local courts to enforce my rights? 	In some jurisdictions it may be necessary to register to do business or to pay stamp taxes or similar fees in order to bring suit in the local courts.
<ul style="list-style-type: none"> Will local courts recognise and enforce a judgment obtained in the courts of the jurisdiction of the governing law of the credit documents? An arbitral award? 	Generally speaking, most courts will recognise foreign judgments and arbitral awards, subject to certain customary limitations.
<ul style="list-style-type: none"> Will local courts recognise and enforce the parties' choice of law as the governing law of the credit documents? 	The courts in most jurisdictions will recognise and enforce the parties' choice of law.
Miscellaneous	
<ul style="list-style-type: none"> Are there any limits on my ability as a foreign entity to own, or obtain a lien on, the commodity? 	Foreign ownership restrictions may exist in some jurisdictions on certain types of commodities.
<ul style="list-style-type: none"> Is the commodity subject to local price controls or other regulations that could negatively impact my ability to sell the collateral and recover my money? 	This might be a problem if you are forced to sell the commodity locally.

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