Perfecting collateral owned by foreign debtors presents a myriad of issues. This session will provide an overview of the best practices for structuring cross-border credits in relation to FX and other risk management exposure. It will also provide guidance for filing UCC-1 financing statements with the D.C. Recorder of Deeds and other perfection methods.

I. Structuring for FX and Derivative Exposure in the Cross-Border Context.

The foreign exchange market is the world’s largest market with over $5 trillion in daily turnover, which is more than 30 times the average volume of all US equity markets. It is a 24-hour market that opens on Sunday morning in Auckland, New Zealand and closes on Friday afternoon at 5 p.m. in New York. The four major market participants are central banks, banking and financial institutions, hedgers, which are customers of the banks and the financial institutions, and speculators.

Hedging allows a company to minimize or eliminate foreign currency exposure by providing it with the ability to lock in exchange rates for a particular period of time in the future. Hedging creates stability in a foreign currency, which permits a company to forecast its international operations based on the exchange rate in which it may operate in versus its functional currency.

However, this exposure is not always contemplated in loan documentation. When structuring credit facilities, counsels for banks and financial institutions should add another layer of diligence to ensure that FX obligations are fully collateralized. Some of the questions that counsel should raise include:

- Does the borrower have any foreign currency exposure?
- Is this exposure hedged?
- Are the hedges in place at the parent level, or is there also hedging at the subsidiary or affiliate level?
- Who are the borrower’s current hedge banks?
- Will the FX exposure be secured or guaranteed?
- Does the borrower have accounts denominated in currency other than the U.S. Dollar?

To avoid underwriting errors, when structuring financing transactions, counsel should note that the FX counterparty may not be the primary borrower but another obligor, and that not all banks in a credit facility are typically FX counterparties. Furthermore, if the FX counterparty is not a lender in the syndicate, parties should determine if the loan documents need to run to their benefit. Documents should also be clear if the lenders are relying on collateral for F/X exposure.
Finally, counsel should be aware that permitted liens and debt covenants can limit or impact F/X as well as the ability to take cash or other future collateral.

II. UCC Filings and Other Perfection Methods in Cross-Border Financings.

The presentation will also cover filing protocols with the D.C. Deed of Recorders’ Office and other techniques used to perfect collateral in cross-border transactions. As background, every state in the US, as well as Puerto Rico, Guam and the US Virgin Islands, has adopted a version of Article 9 of the Uniform Commercial Code (the “UCC”) that governs various aspects of commercial transactions, including the creation and perfection of security interests. Under the UCC, with limited exceptions, a secured party can perfect a security interest in substantially all of the personal property of an obligor with the filing of a single UCC-1 financing statement.

The proper place for filing for most types of collateral is the “location” of the obligor (as determined for purposes of the UCC). Since most non-US jurisdictions do not have a “UCC type filing system”, a special rule exists for determining the proper place for UCC filings to be made against non-US obligors. However, the UCC rules also address the possibility that other jurisdictions may have some type of a central registry for recording security interests in personal property that can be searched by prospective secured parties to determine the existence of any other security interests. A key consideration is whether prospective secured parties can rely upon the filing system to establish the priority of their security interests in an obligor’s collateral.

The proper place for filing of a UCC-1 financing statement to perfect a security interest in most types of collateral is the “location” of the obligor. §9-301 sets out the general rule that the law that governs perfection of a security interest is the state in which the obligor is located. §9-307(b) further clarifies that an obligor which is an organization with only one place of business is located at its place of business, and an obligor that has more than one place of business is located at its chief executive office. This rule applies to both US and non-US organizations. If such location is in a US state, the proper place for filing would be that state. Since non-US organizations are more likely to have their principal office/chief executive office in their home jurisdiction, the application of this rule would mean that for purposes of applicable UCC law, the perfection of security interests in the collateral of a non-US obligor would be governed by the local law of its jurisdiction of formation.

Under §9-307(c), an obligor that maintains its sole place of business or chief executive office in a jurisdiction other that a state in the US is “located” for purposes of UCC Article 9 in the District of Columbia, and therefore the proper place for filing the UCC-1 financing statement is the Recorder of Deeds in DC.

The session will conclude with illustrations of the foregoing perfection rules by providing examples of when to file UCC-1 financing statements in different cross-border financing transactions.
Cross-border Financings: Structuring for FX and Derivative Exposure: Perfecting Foreign Collateral

American Bar Association, Business Law Section Meeting
Washington, D.C.

Cheryl Isaac | Senior Counsel | Michael Best & Friedrich LLP
Barbara Meeks | Member | Moore & Van Allen PLLC
Roshelle Nagar | Counsel | Weil, Gotshal & Manges LLP
Nancy Rigby | Assistant General Counsel | U.S. Bank National Association
Tracy Springer | Senior Legal Counsel | HSBC Bank USA, N.A., Global Banking & Markets
Moderator - Arleen Nand | Shareholder, Greenberg Traurig, LLP

SEPTEMBER 13, 2019
Perfection of Security Interests in Collateral of Foreign Obligors

Roshelle A. Nagar

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Cross-Border Financings: Collateral

- The scope of a collateral package in cross-border financings raises unique issues relating to credit support
  - Local law considerations regarding costs and complexity
  - Governing law of collateral documentation
  - Applicable choice of law
  - Enforceability

- Considerations for structuring a foreign collateral package include:
  - Agreed Security Principles for the overall transaction (set forth in the primary debt documentation)
    - Set of principles which establish guidelines and parameters for the guarantees and security to be provided by the loan parties
    - Balances the company’s desire to minimize disruption to its business with the lender’s need for credit support and ability to enforce its security interest in the collateral
      - Reflects cost/benefit analysis
  - Tax and Regulatory considerations
  - Designation of “Material Subsidiaries” (based on asset value and cash flow)
Security Interests: Perfection by Filing

- Every state in the US, as well as Puerto Rico, Guam and the US Virgin Islands, has adopted a version of Article 9 of the Uniform Commercial Code (the “UCC”) that governs various aspects of commercial transactions, including the creation and perfection of security interests
  - Under the UCC, with limited exceptions, a secured party can perfect a security interest in substantially all of the personal property of an obligor with the filing of a single UCC-1 financing statement
  - The proper place for filing for most types of collateral is the “location” of the obligor (as determined for purposes of the UCC)
  - Since most non-US jurisdictions do not have a “UCC type filing system”, a special rule exists for determining the proper place for UCC filings to be made against non-US obligors
  - However, the UCC rules also address the possibility that other jurisdictions may have some type of a central registry for recording security interests in personal property that can be searched by prospective secured parties to determine the existence of any other security interests
    - A key consideration is whether prospective secured parties can rely upon the filing system to establish the priority of their security interests in an obligor’s collateral
Uniform Commercial Code: Filing Rules

- The proper place for filing of a UCC-1 financing statement to perfect a security interest in most types of collateral is the “location” of the obligor
- §9-301 sets out the general rule that the law that governs perfection of a security interest is the state in which the obligor is located
  - §9-301(a) provides that “while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection and priority of a security interest in collateral”
- §9-307 sets out the rules that determine the location of the obligor based on entity type, jurisdiction of formation and place of business
  - §9-307(b) sets out the general rule that an obligor that is an organization that has only one place of business is located at its place of business and an obligor that has more than one place of business is located at its chief executive office
    - This rule applies to both US and non-US organizations
    - If such location is in a US state, the proper place for filing would be that state
    - Since non-US organizations are more likely to have their principal office/chief executive office in their home jurisdiction, the application of this rule would mean that for purposes of applicable UCC law the perfection of security interests in the collateral of such non-US obligor would be governed by the local law of its jurisdiction of formation
§9-307(e) includes an exception for a US registered organization and provides that such an organization is located in its jurisdiction of formation.

Even if a non-US obligor is a registered organization in its home jurisdiction, it will not fit into the exception in §9-307(e) for “registered organizations” because it is not a “registered organization” within the meaning of §9-102(a)(71) (i.e., organized under the law of a single state or the United States).

However, since Article 9 of the UCC adopts a comprehensive approach to determining location for all obligors, a special rule was included in §9-307 to determine the proper place for filing for non-US obligors.
§9-307(c) establishes the “location” of obligors that are registered outside of the US

- (c) Limitation on applicability of subsection (b). Subsection (b) applies only if a debtor's residence, place of business or chief executive office, as applicable, is located in a jurisdiction whose law generally requires information concerning the existence of a nonpossessory security interest to be made generally available in a filing, recording or registration system as a condition or result of the security interest’s obtaining priority over the rights of a lien creditor with respect to the collateral. If subsection (b) does not apply, the debtor is located in the District of Columbia. [emphasis added]

- Under §9-307(c), an obligor that maintains its sole place of business or chief executive office in a jurisdiction other than a state in the US is “located” for purposes of UCC Article 9 in the District of Columbia, and therefore the proper place for filing the UCC-1 financing statement is the Recorder of Deeds in DC
  - Cayman Islands exempted limited partnership with its chief executive office in the Cayman Islands - assuming that the Cayman Islands does not have a UCC type filing system, file in DC
  - Cayman Islands exempted limited partnership with more than one place of business and its chief executive office in New York - file in NY
  - Cayman Islands exempted limited partnership with one place of business in Michigan - file in Michigan
UCC Filings against non-US obligors

- The policy underlying UCC §9-307(c) is to:
  - streamline filing and searching against non-US obligors
  - promote consistency and predictability of recordation of security interests
  - facilitate lower cost of credit for borrowers

- Identifying a UCC type or UCC equivalent filing/notice system
  - “The purpose of the “equivalence test” is to limit applicability to those foreign legal systems that are UCC equivalent in all material respects to the principles of notice filing
    - Does the local jurisdiction have a filing, recordation or registration system for nonpossessory security interests in personal property?
    - Does local law generally require filing in that registration system to achieve priority over competing lien creditors? (note that alternative methods of perfection in some types of collateral are still ok)
    - Is filing information in that registration system is available to third party searchers?

- Issues
  - Some registration systems cover only limited categories of collateral
  - Some registration systems are not reliably searchable
  - Some registration systems don’t establish priority
Other Considerations

- Potential enforceability issues in jurisdiction of formation of non-US obligor
  - Can't assume that a foreign court would recognize the validity or priority of a security interest created under the UCC and perfection by a DC filing

- Under applicable conflicts of law principles, for most tangible collateral the “location of the debtor” rule only governs perfection, and not the effect of perfection or nonperfection or the priority of the security interest
  - for example, if a security interest in inventory of a French obligor is perfected by a UCC filing in DC but the inventory is located in France, priority would be governed by applicable French law and not the DC UCC

- For most intangible collateral, the DC UCC will determine whether the security interest is properly perfected and whether it has priority over other security interests (but there still may be potential enforceability issues in the obligor’s jurisdiction of formation)

- For those types of collateral (i.e. certificated securities; deposit accounts) that can (or must) be perfected by non-filing methods (i.e., control), the manner of perfection with respect to non-US obligors is identical to that of US obligors
Cross-Border Bilateral Model

- US Bank makes Loan to US Subsidiary of Foreign Multinational Client
- Primary Credit Support is Cross-Border Guaranty from Corporate Parent
  - Governed by Local Law of Guarantor’s Home Country
  - Reviewed by Internal Counsel in Guarantor’s Home Country
  - Often on Standard Form
  - Domestic Collateral Only; perfection governed by US Law (Security Agreement + Filing)
  - Lower Costs, Quick Turnaround Time
Challenges Faced When Relying on Foreign Collateral

- Less certainty of perfection in jurisdictions without UCC-style filing
- High costs of perfecting foreign collateral
- Different market practices for opinion delivery
- Different legal documentation forms
- Different lien concepts
- Lack of Certainty for Recovery
Foreign Exchange Considerations in Financing Transactions: Overview of FX Products

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Nancy Rigby
Assistant General Counsel, U.S. Bank National Association
The world's largest market

The Foreign Exchange market is the world's largest market with over $5 trillion turnover on a daily basis (more than 30 times the average volume of all US equity markets)

24-hour market: opens Sunday morning in Auckland, New Zealand, closes Friday afternoon at 5PM in New York, US

Trade flows, speculative or otherwise, cause exchange rates to change every second of the day, 24 hours a day

Top Traded Currencies

- USD: 89%
- EUR: 37%
- JPY: 20%

Top Traded Pairs

- EURUSD: 28%
- USDJPY: 17%
- USDGBP: 14%
Market Participants

The four main players in the forex market have different functions and motivations.

Governments & Central Banks
- In most countries, the central bank works with the government, or as an extension of the government, to conduct policy.
- Central Banks are often involved in maintaining foreign reserve volumes and will use the foreign exchange market to adjust their reserve volumes.

Banks & Financial Institutions
- Banks and Financial Institutions make up the interbank market.
- Banks will make currency transactions based on credit.

Hedgers
- Hedgers are customers of Banks & Financial Institutions.
- Most commonly, hedgers are businesses that look to manage volatility as management and shareholders hate uncertainty.

Speculators
- Speculators look to make money by taking advantage of fluctuation of exchange rate movements.
- The largest speculators in the Foreign Exchange market are hedge funds.
FX Risk Management – What is Hedging?

**Definition:**
A method for a company to minimize or eliminate foreign currency exposure(s). A hedge is a type of derivative, or financial instrument, that derives its value from an underlying asset. Hedges provide the ability to lock in exchange rates for a particular period of time in the future.

Two common financial instruments used for hedging are forwards and options.

**Purpose:**
Hedging creates stability in a foreign currency, which permits a company to plan and forecast its international operations based on the exchange rate in which they may operate in versus their functional currency.

**Types of Hedging:**
Companies that conduct business across borders have exposure to foreign currencies. This exposure either comes from a payment or receipt in foreign currency. Hedging helps manage risk of unfavorable exchange rate movement before the currency is exchanged.

- Cash flow – Locking in an exchange rate for a payable or receivable for a future activity
- Balance sheet – Locking in an exchange rate for balance sheet items between financial periods
FX Products and Common Terms

• **Trade Date** – Date on which transaction is executed whether verbally or electronically.

• **Value Date / Settlement Date** – Date on which funds flow. Usually two business days after the trade date.

• **Spot Contract** – Buy or sell foreign currency at today’s market exchange rate. Delivery occurs two business days later.

• **Forward** – A contractual obligation to buy or sell a foreign currency at an agreed rate. Parties agree to a determined rate today for settlement on a future date. Used to lock in an exchange rate for a known cash flow (i.e. payable or receivable) to be received at a specific future point in time.

• **Non-Deliverable Forward** – An outright forward contract in which counterparties settle the difference between the prevailing market exchange rate and agreed upon exchange rate upon settlement. The notional amount of an NDF is never exchanged. The only exchange of cash flows is the difference between the NDF rate and the prevailing spot market rate (at time of fix). Allows a company to hedge foreign currency risk where no forward market exists. Typically used to hedge transactions in emerging market countries. Contract is typically settled in USD.

• **Swap** – Simultaneous purchase / sale or sale / purchase of one currency against another for two different value dates.

• **Option** – An option gives the buyer the right but not the obligation, to buy or sell a specific quantity of a specific financial instrument (i.e. a currency) at a specific rate on or before a specific future date. For this right, the buyer pays a premium.
Questions to Ask

- Does the company have any foreign exposures?
- Does the company hedge those foreign exposures?
- What types of FX products do they use? What are the tenors of the trades?
- Are the hedges just at the parent level, or is there also hedging at the subsidiary or affiliate level? Could there be in the future?
- Who are the company’s current hedge banks?
- Will the FX exposure be secured or guaranteed?
- Does the company have accounts denominated in currency other than U.S. Dollar?
- Consider anticipated cross-border M&A
- Ask for copies of existing ISDAs and Credit Support Annexes
Lender and Counterparty Issues

• F/X counterparty is often an obligor other than the borrower
• Multiple and new F/X obligors
• Required and Permitted Hedge Provisions should be clear F/X is permitted
• Foreign obligors and documentation enforceability
• Not all banks in facility are typically F/X counterparties
• Is the F/X counterparty the lender or a different entity, and do the documents run to their benefit?
Loan Document Definitional Issues

• Clear intent if F/X should be supported by the Loan Documents, or is a completely separate obligation
• Hedge vs. Bank Product definition (cash management/spot trades vs. a forward)
• Hedge should be specifically referenced in Obligations definition
• Hedge or Swap definition should not be tied to Credit Agreement or Loan Documents (i.e. arising under, pursuant to, or in connection with; “including, without limitation”)
• Documentation may have separate definitions and construct, particularly if a foreign jurisdictional document for a foreign obligor
• Should be clear if relying on collateral for F/X
• Permitted Liens and Negative Covenants for Indebtedness can limit or impact F/X, ability to take cash or other future collateral
• Waterfall/Priority with Default-may have a separate waterfall for foreign obligations with different remedies
• Inter Creditor Agreement or Subordination with a lower priority for F/X
Additional Loan Document Issues

- Notice requirements or agent or required lender approvals for F/X and other swaps
- Priority in waterfall can be contingent on notice or other required information
- Difficult to comply with notice/approval requirements for short term F/X
- Continuing support if no longer a lender; release/hedge termination limiting language
- Loan Document issues should be addressed/correlate with ISDA and ATE; look for gaps, inconsistencies and ambiguities (ATE unsecured, no longer a lender, etc.)
ISDA Document Architecture

ISDA Master Agreement

- Derivatives are governed by the ISDA Master Agreement (a separate legal document from the “related” loan documents)
- Contains the basic legal terms applicable to all derivatives between bank and customer
- Universally adopted, never changed or negotiated
- Intended to be even-handed; representations, covenants, termination events, and defaults apply to both parties equally

Schedule to Master Agreement

- Allows bank to customize swap to its credit, collateral, and legal requirements
- Adds additional events of default (termination events)
- Adds cross-defaults to different loan agreements and to subsidiaries and affiliates
- Adds cross-collateralization, guarantors, etc.; note that for real property, addressing security in the schedule is not sufficient to protect the bank
- Unlike the Master Agreement, the schedule is often “negotiated”

Confirmation

- Contains the economic terms of transaction
- Note that confirmation is required for initial trade, as well as any amendments or voluntary termination prior to maturity
- In the event of a conflict between the terms of the confirmation, schedule, and ISDA Master, conflicts are resolved in the reverse priority listed on this page
Key FX Documentation Considerations

- Specified Entities
- Cross-Default
- Termination Currency
- Additional Termination Events
- Credit Support Provider / Credit Support Document
- Etc.
FX and the Dodd-Frank Act

• The following are treated as “swaps” and regulated as such under the Dodd-Frank Act:
  • Foreign currency options
  • Non-deliverable FX forwards
  • Currency Swaps
  • Cross-Currency Swaps

• The following are exempt FX swaps, but still subject to certain lesser regulatory requirements:
  • FX swaps
  • FX forwards

• All of these types of transactions must be reported, and are subject to the CFTC’s external business conduct standards and anti-evasion rules
Regulatory Basics – Eligible Contract Participants

1. **Only** “Eligible Contract Participants” ("ECPs") may enter into Swaps (previous “business purpose” exemption is gone)

2. **ECPs generally include:**
   - Entities with $10 million in total assets, or
   - Entities with a net worth of at least $1 million and are hedging.
   - Individuals with “amounts invested on a discretionary basis” that exceed $10 million, or $5 Million if hedging

3. **If counterparty does not satisfy the requirements above, it may qualify:**
   - Under another Section of the ECP definition
   - Through a guaranty by **certain** ECPs (i.e. entities with more than $10 million in total assets)
   - If 100% of the owners of an entity are ECP
   - Under the CFTC No Action Letter 12-17 as an "indirect proprietorship"
   - As an "anticipatory ECP"

4. **Party must make “good faith efforts” to comply with this rule, specifically:**
   - Implement and follow reasonably designed policies and procedures to verify ECP status of party; and
   - Comply with policies and procedures in “good faith".
Regulatory Basics – Recordkeeping and Reporting

1. Dodd-Frank includes rules which require all swap counterparties to maintain specific data and which require all swaps to be reported to a Swap Data Repository (even for Non-Swap Dealers and Non-financial institutions)

2. Reporting obligation includes new swaps and historical swaps.

3. Generally, a bank customer will satisfy its reporting obligation by requiring the bank to report on its behalf

4. LEI/GMEI: All parties to a transaction must have a Legal Entity Identifier (LEI, a/k/a, Global Markets Entity Identifier (GMEI))

5. LEIs also needed for certain historical swaps.