An Introduction to Legal Risk and Structuring Cross-Border Lending Transactions

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1. Introduction: The Rise of Cross-Border Lending

Introduction. Welcome to this inaugural issue of *The International Comparative Legal Guide to: Lending and Secured Finance*. Our contributing authors have worked to provide a quick guide to many of the most common issues that arise in cross-border lending transactions. We hope you find the overview chapters and the country chapters that follow useful and practical, and we encourage you to contact us with suggestions to improve future editions of the Guide.

Increase in Cross-Border Lending. Cross-border lending has increased dramatically over the last two decades in terms of volume of loans, number of transactions and number of market participants. According to Dealogic, global syndicated loans totaled approximately $3.4 trillion in 2012, an increase from $1.2 trillion in 2002. Global bilateral-lending has undergone a similar transformation. There are many reasons for this increase: the globalisation of business and development of information technology; the rise of emerging economies that have a thirst for capital in order to develop their economies to their full potential; and the development of global lending markets, especially in the US, which has led to a dramatic rise in the number of market participants searching for the right mix of yield and risk in the loan markets, a search that often leads to cross-border lending opportunities.

Challenges of Cross-Border Lending. For those lenders and lawyers who practice in the cross-border lending area, whether in the developed economies or the emerging markets, this is a dynamic and exciting time. In addition to understanding the creditworthiness of a potential borrower, the overlay of exposure of a lender to a foreign jurisdiction entails analysis of a myriad of additional factors, the weighting of which will vary from country to country, and many of which are overlapping. This mix of political, economic and legal risks, bundled together, are referred to collectively as *country risk*. Understanding country risk is imperative for a lender to price a cross-border loan and for investors to be able to compare debt instruments of similarly-situated companies located in different countries.

Examination of Legal Risk. This first overview chapter of the Guide provides some observations on an element of country risk that is closest to the hearts of lawyers: *legal risk*. Together with tax considerations, understanding legal risk can be important for structuring cross-border loan transactions. But what exactly is legal risk? Can legal risk be measured? What tools do lenders traditionally use to mitigate legal risk? Do these tools work? Finally, we complete this chapter with some observations on how conventional notions of legal risk are being challenged.

2. Legal Risk in the Cross-Border Lending Context

What is Legal Risk? Young lending lawyers are taught that when a loan transaction closes, "the borrower walks away with a pile of the lender's money and the lender walks away with a pile of paper *and the legal risk*". If the borrower refuses to pay the money back, then the lender must rely on the *pile of paper and the legal process*, in order for the money to be returned. This notion helps drive the point home that legal risk is primarily something that keeps lenders (rather than borrowers) awake at night. While there is no settled description of legal risk, it can be thought of as having a number of components, starting with *documentation risk*, which is mitigated by having competent counsel ensure that legal documentation correctly reflects the business arrangement and is in the proper form. In a cross-border lending context it is useful to think of legal risk as having two additional related and sometimes overlapping components: (1) *enforcement risk*, and (2) *the risk of law reform*.

Enforcement Risk. Lenders want to enter a lending transaction knowing that a number of "enforcement components" are in place to allow for enforcement of loan documentation (that *pile of paper*) and to resolve disputes and insolvency in a predictable way. These components include a well-developed body of commercial law, an independent judiciary and an expedient legal process. This reliance can be in the context of an unsecured loan, a secured loan or an insolvency of the borrower, since as a general matter courts have the power to adjudicate issues with respect to property of a company located in their jurisdiction. Thus, in a cross-border lending context, especially if a borrower's primary assets are located in a foreign jurisdiction, there is typically some reliance by a lender on the laws, legal institutions and legal process of that foreign jurisdiction.

For example, a US lender seeking to enforce a loan agreement against a foreign borrower could do so in one of two ways. Assuming the borrower has submitted to the jurisdiction of New York courts, the lender could file suit in New York against the borrower, obtain a judgment from a New York court, and then seek to have that judgment enforced against the assets of the borrower in the borrower's home country. In the alternative, the lender could seek to enforce the loan agreement directly in the courts of the foreign jurisdiction. In either case, there is reliance on the laws, institutions and legal process in the borrower's home jurisdiction. If the foreign jurisdiction's local law is not consistent with international norms, or its legal institutions are weak, corrupt or subject to undue political influence, then *enforcement risk* may be considered high. It should be noted that enforcement risk may be high even in a jurisdiction that has modernised its commercial laws if legal institutions have not also matured (the latter taking more time to achieve).

Law Reform Risk. Lenders also want to know that the laws they are exposed to in connection with a loan to a borrower will not arbitrarily change to the lender's detriment. This aspect of legal risk is closely associated with political risk. Law reform risk detrimental to lenders is at its highest when a country is undergoing some sort of systemic crisis. For example, in 2002 during Argentina's financial crises, the government of Argentina passed a law that converted all obligations of Argentine banks in US dollars to Argentine pesos. Given that pesos were only exchangeable at a fixed rate that did not accurately reflect a true market rate, this change in law had the effect of immediately reducing the value of the lenders' loans.

Why Legal Risk Matters. If enforcement risk is high, this weakens a lender's negotiating position in the case of a workout of a loan (as compared to a similarly situated borrower in a country where enforcement risk is low). If law reform risk is high, lenders risk a multitude of unsettling possibilities, some examples of which are described below. In each case, this increased risk should be reflected in increased pricing. In cases where the risk and/or pricing of a loan is considered too high, then a loan transaction may be structured in order to attempt to mitigate the legal risk and/or reduce pricing. Lenders have a number of tools at their disposal in order to mitigate legal risk. In this way, loan transactions that might otherwise not get done, do get done.

3. Can Legal Risk be Measured?

Before examining ways to mitigate legal risk, it is interesting to examine the extent to which legal risk can be measured. Measuring legal risk certainly is not an exact science, though it nevertheless can be a useful exercise to consider yardsticks that might provide a sense of one country's legal risk relative to another's. A threshold challenge is that while there are many tools available to measure *country risk*, as mentioned above *legal risk* is only one component of country risk. Nevertheless, there are some tools that may be helpful. In terms of measuring legal risk, the conventional wisdom is that developed economies have stronger legal institutions and less legal risk when compared to emerging market jurisdictions.

The Usefulness and Limitations of Sovereign Ratings. Sovereign ratings measure the risk of default on a sovereign's debt. These ratings are useful to get a "systemic" view of how a country is doing economically. A country that has a high sovereign debt rating is likely to be financially stable. A country that is financially stable is less likely to undergo systemic stress, at least in the short term, and therefore less likely to undergo law reform adverse to lenders (remember the link between systemic stress and law reform noted above).

But does it follow that there is a correlation between a sovereign's rating and *enforcement risk* against private borrowers in the sovereign's jurisdiction? A sovereign's risk of default on its debt instruments may be low because the country has extensive state-owned oil production that fills the country's coffers. This would not necessarily indicate that a country's legal institutions would fairly and efficiently enforce a pile of loan documents against a borrower in that jurisdiction - the legal institutions in such a country might be as corrupt and/or inefficient as the day is long. While a quick review of sovereign ratings does suggest that there is at least some correlation between ratings and enforcement risk, there are also some outliers (for example, Bermuda and China have similar sovereign ratings, though international lenders probably consider enforcement risk to be more significant in China than in Bermuda).

Sovereign Rate Spreads and Sovereign Credit Default Swap Prices. One of the simplest and most widely used methods to measure *country risk* is to examine the yields on bonds issued by the country in question compared to a "risk free" bond yield (still usually considered the US, notwithstanding the recent credit downgrade). A comparison of sovereign debt credit default swap prices provides a similar measure. As with sovereign ratings, this tool is useful to obtain a measure of potential systemic stress and *law reform risk* but seems less useful in terms of measuring *enforcement risk* of a borrower in that jurisdiction for the same reasons provided above.

Recovery after Default Analysis. A type of analysis performed by ratings agencies that might be considered useful for measuring legal risk from country to country is corporate default and recovery analysis. A reasonable hypothesis might be that the average recovery for creditors after a borrower default would be higher for countries with low legal risk: stronger institutions means higher recoveries for creditors. But a review of the data suggests there is little or no such correlation. Why is this? There are a few possible explanations: recovery rates depend on a variety of factors other than legal risk, including the severity of default and the makeup of the individual borrowers subject to the analysis. It also is probable that lenders in a country with strong legal institutions (and low risk) may be more willing to make "riskier" loans (based on a portfolio theory of investment) given they have confidence in the jurisdiction's strong legal institutions to resolve defaults and insolvency in a predictable manner.

World Bank "Doing Business" Rankings. The World Bank publishes an interesting study each year titled the *Ease of Doing Business Rankings*. These rankings rate all economies in the world from 1 to 185 on the "ease of doing business" in that country, with 1 being the best score and 185th the worst (see http://doingbusiness.org/rankings). Each country is rated across eleven categories, including an "enforcing contracts", "resolving insolvency" and "protecting investors" category. The rankings provide a helpful tool for comparing one country to one another. While there is not space to detail the methodologies of the rankings in this chapter, the methodologies can produce some strange results. For instance, in the 2013 rankings both Belarus and the Russian Federation have a better "enforcing contracts" score than Australia. Nevertheless, these rankings can be a useful benchmark and are worthy of mentioning.

Subjectivity. Ultimately, in addition to the quantitative and qualitative data described above, a lender's perception of the legal risk of lending into a particular country will be driven by a number of geographic, historical, political, cultural and commercial factors peculiar to the lender and the country in question. For example, as a general matter, French lenders seem more comfortable than US lenders when lending to borrowers in Africa, while US lenders seem generally more comfortable than French lenders lending to borrowers in Latin America. (English lenders seem comfortable lending anywhere!) Lenders will measure legal risk differently based on their institution's experience and tools at hand to work out a loan should it go bad.

4. Tools Used to Mitigate Legal Risk

The fact that a borrower is located in a jurisdiction with a high level of legal risk does not mean that a loan transaction cannot be closed. Lenders have been closing deals with borrowers in far-off lands since the Venetians. Today, lenders use a number of tools to help mitigate legal risk, both in terms of structuring a transaction and otherwise. These concepts are used in all sorts of financings, from simple bilateral unsecured corporate loans to large, complicated syndicated project financings with a variety of financing parties. Which of these tools will be available to a lender will depend on a variety of factors, especially the relative negotiating positions of the borrower and lender for a particular type of transaction. Observations on the effectiveness of certain of these tools in practice are provided in section 5.

Governing Law. As a starting point, the choice of governing law of a loan agreement is important because it will determine whether a contract is valid and how to interpret the words of the contract should a dispute arise. The governing law of most loan agreements in international transactions has historically been either New York or English law. This is primarily because these laws are considered sophisticated, stable and predictable, which lenders like. Also, lenders generally prefer not to have a contract governed by the law of a foreign borrower's jurisdiction, since lawmakers friendly to the borrower could change the law in a way detrimental to the lender (law reform risk). As part of any cross-border transaction, lending lawyers spend time ensuring that the choice of governing law will be enforceable in the borrower's jurisdiction, often getting coverage of this in a legal opinion delivered at closing.

Recourse to Guarantors in a Risk-Free Jurisdiction. A lender to a borrower in a jurisdiction with high legal risk may require a parent, subsidiary or other affiliate of the borrower in a "risk-free" jurisdiction guarantee the loan. In this type of situation, the lender would want to ensure that the guaranty is one of "payment" and not of "collection", since the latter requires a lender to exhaust all remedies against a borrower before obligating the guarantor to pay. In a cross-border context, this could result in a lender being stuck for years in the quagmire of costly enforcement activity in a foreign and hostile court. While almost all New York and English law guarantees are stated to be guarantees of payment, it is nevertheless always wise to confirm this is the case, and especially important if the guarantee happens to be governed by the laws of another jurisdiction.

Collateral in a Risk-Free Jurisdiction. With secured loans, if the legal risk of a borrower's home country is high, lenders will often structure an "exit strategy" that can be enforced without reliance on the legal institutions of the borrower's jurisdiction. This has been a classic tool of project finance lenders for decades and has contributed to the financing of projects in a variety of countries that have high legal risk.

a. Offshore Share Pledge. For example, a lender often requires a share pledge of a holding company that ultimately owns the borrower. This type of share pledge may be structured to allow for an entity organised in a risk-free jurisdiction to pledge the shares of the holding company, also organised in a risk-free jurisdiction, under a pledge document governed by the laws of a risk-free jurisdiction. Such a pledge, properly structured and vetted with local counsel, is a powerful tool for a lender, allowing a lender to enforce the pledge and either sell the borrower as a going concern to repay the loan or to force a replacement of management. In the case of such a pledge, it is important to ensure that the borrower's jurisdiction will recognise the change in ownership resulting from enforcement of such a pledge under its foreign ownership rules. When preparing such a pledge, it is important to carefully examine the enforcement procedures to ensure that the pledge can, to the maximum extent possible, be enforced without reliance on any cooperation or activity on the part of the borrower, its shareholders or directors.

b. Offshore Collateral Account. Another classic tool is to require a borrower to maintain an "offshore collateral account" in a risk-free jurisdiction into which the borrower's revenues are paid by its customers. In project finance structures, lenders will often enter into agreements with the borrower's primary customers requiring that revenues be paid into such an account so long as the loans are outstanding. It is important to point out that these accounts will only be as valuable as the willingness of customers to pay revenues into them. Creditworthy, offshore customers from jurisdictions where the rule of law is respected are likely to provide more valuable credit enhancement than customers affiliated with the borrower and located in the same jurisdiction.

c. Playing Defence and Offence. It should be noted that, in the case of a secured transaction, offshore collateral should not be viewed as a substitute for the pledge of the borrower's local assets. In such a case, a pledge of local assets is also vitally important since, at least theoretically, it preserves the value of the lenders claim against those assets against third party creditors. To use a football analogy, collateral can be thought of as having an "offensive" component and a "defensive" component: the pledge of local assets to the lender is a "defensive" move because this keeps other creditors from obtaining prior liens in these assets, while an equity pledge might be considered an "offensive" tool, allowing the lender to foreclose and sell a borrower quickly and efficiently in order to repay a loan with the proceeds.

Partnering with Multilateral Lenders or Export Credit Agencies. A multilateral development bank is an institution (like the World Bank) created by a group of countries that provides financing and advisory services for the purpose of development. An export credit agency (ECA) is usually a quasi-governmental institution that acts as an intermediary between national governments and exporters to provide export financing. Private lenders to borrowers in risky jurisdictions are often comforted when these government lenders provide loans or other financing alongside the private lenders to the same borrower, the theory being that the "governmental" nature of these institutions provides additional leverage to the lenders as a whole given these entities are considered to be more shielded from possible capriciousness of a host country's legal and political institutions.

Reputation in the Capital Markets. A borrower or its shareholders may be concerned with their *reputations* in the capital markets in connection with a long and contentious loan restructuring exercise. This may be particularly true in the case of family-owned conglomerates in emerging markets, especially if other parts of the business need to access international financing. If access to the capital markets is not considered to be important, they may be willing to weather the storm. *See* T. DeSieno & H. Pereira, *Emerging Market Debt Restructurings: Lessons for the Future*, 230 N.Y.L.J. 39 (2003). In sovereign or quasi-sovereign situations, a government *seeking foreign investment* or striving to *maintain good relations with the international capital markets* is less likely to be heavy-handed in a dispute with international investors. While Argentina today probably does not fall into this category, in our firm's experience it has been the case in certain other emerging market jurisdictions.

Personal Relationships. The value of personal relationships should not be overlooked in mitigating legal risk. While personal relationships are important in both the developed and emerging markets, personal relationships play a particularly special role in those countries that do not have well-developed institutions and processes to resolve disputes. Some institutions, when working out problem loans in emerging markets, often turn the loan over to different personnel than those who originated the loan. In certain cases, it may be helpful to keep those with the key personal relationships with the borrower involved in these negotiations.

Political Risk Insurance and Credit Default Swaps. A lender may purchase "insurance" on a risky loan, in the form of political risk insurance or a credit default swap. Rather than mitigating risk, this instead shifts the risk to another party. As such, this is a good tool to have in the lender's toolbox.

Why Good Local Counsel is Important. Finally, the value of high-quality local counsel in a cross-border loan in a high-risk jurisdiction cannot be overstated. This value comes in 3 forms: knowledge of local law and which legal instruments provide the most leverage to lenders in an enforcement situation; providing local intelligence on where other "leverage points" may be; and finally, by being well-connected to the local corridors of power and thereby being able to predict or "deflect" law reform in a manner helpful to clients. For local counsel in high-risk jurisdiction, it's best not to be penny-wise.

5. Recent Developments and Anecdotes that Both Support and Challenge the "Conventional Wisdom"

The Sovereign Debt Crisis: Ireland and Greece. As mentioned above, the conventional wisdom suggests that legal risk is higher in the emerging markets than in the developed economies. But consider what happened to creditors in Ireland and Greece recently. In both cases, lawmakers in these countries changed the law in a manner that materially and adversely impacted the rights of creditors. In Ireland, Irish lawmakers changed the bank resolution rules to *favour equity over debt*. In Greece, lawmakers changed Greek law in a way that allowed for collective active mechanics in a form that did not exist previously, effectively forcing minority shareholders to be bound by a majority vote. *See* T. DeSieno & K. Dobson, *Necessity Trumps Law: Lessons from Emerging Markets for Stressed Developed Markets?* (Int'l Ass'n of Restructuring, Insolvency and Bankruptcy Professionals, International Technical Series Issue No. 25, 2013). These and other examples make clear that even, in the so-called developed economies, law reform can be a risk to creditors, especially when economies are under systemic stress.

Why New York or English Law is Still a Good Choice. In the Greek situation mentioned above, the majority of Greek bonds were issued under Greek law and some bonds were issued under English law. Bondholders holding English law governed bonds did not suffer the same consequence of the change in Greek law (since Greek lawmakers could not change English law). In this instance at least, the conventional wisdom held true.

Why Local Law May Sometimes Be A Better Choice. In a recent transaction in the emerging markets, lenders were provided with a choice to have a guarantee governed by either New York law or local law. Conventional wisdom would suggest the lenders should opt for New York law. However, on the advice of a top local law firm, the lenders opted for the guarantee to be governed by local law. Why? Because after considerable weighing of risks and benefits (including the law reform risk associated with the choice of local law) it was determined that the local law guarantee would provide considerably more leverage against the guarantor in the event of enforcement. It could be enforced more quickly and efficiently in local courts than a New York law guarantee (used by other creditors under other facilities) thus potentially providing an advantage to its beneficiaries. This notion of local law being better is probably more often going to be the exception rather than the rule.

Are Offshore Share Pledges Really Risk-Free? Even in cases of offshore pledge agreements that are perfectly documented as described above, lenders who have tried to enforce these pledges have sometimes run into difficulties. In jurisdictions with high legal risk, borrowers and their shareholders can prevent lenders from being able to practically realise on the value of their collateral in a number of ways: they may use the local legal system to their advantage by making baseless arguments that the change of ownership should not be legally recognised, they may transfer assets to other affiliated companies in violation of contractual obligations, or engage in countless other activities unimaginable to lenders when the loan was closed. This "hold-up" value effectively gives the borrower and its shareholders leverage not available in risk-free jurisdictions, even when the equity is "out of the money".

Does Teaming Up With Government Lenders Help or Hurt Private Lenders? As mentioned above, private lenders are often comforted when government lenders co-lend to a borrower. Is this comfort warranted? Government lenders may have motivations during a workout that extend beyond recovery on debt to other goals. These goals may be maintaining good relationships with the foreign country in question, maintaining employment at home (in the case of ECAs), or instituting environmental, anti-terrorism or other policy goals. Experience with government lenders in restructuring exercises suggests that government lenders may be less willing to engage in difficult negotiations with foreign borrowers and, in the eyes of at least some private investors in certain restructuring exercises, their inclusion in a transaction has led to decreased recoveries. While government lenders can certainly be helpful to a workout process under the right circumstances, private lenders should be clear-sighted on the benefits government lenders provide.

Challenges to New York and English Law? As transaction and insolvency laws in emerging markets are modernised and become more uniform, and as legal and political institutions develop and mature, many local borrowers may push harder for local law to govern their loan agreements. At a recent syndicated lending conference focused on Latin America, local lenders in the region made clear they thought they had a competitive advantage over international lenders because they had an ability to make loans under local law, something local corporate borrowers seemed to value. The extent to which the market would soon see syndicated loans governed by local law was much discussed. While this phenomenon likely may not occur on a significant scale in the near term, it does seem that the choice of governing law may be one consideration that is increasingly in play when lenders are competing for lending mandates.

6. Final Thoughts

With the world becoming smaller, emerging markets developing and lenders searching for yield, more lenders will seek opportunities in cross-border lending. As a result, the question of legal risk will be one of increasing relevance, and local knowledge will be of increasing importance.

Lenders have a number of useful tools available to help mitigate legal risk. Ultimately, it may not be possible to reduce risk to that of a "risk-free" jurisdiction. Lenders should be careful to not overestimate the comfort certain structural tools will ultimately provide. A borrower and its shareholders in a jurisdiction where the rule of law is weak typically enjoy a significant advantage over a foreign lender in a debt restructuring exercise.

Focus on structural tools should not overshadow perhaps the most important mitigant of all: the best protection against legal risk is to make a good loan to a responsible borrower with "sound commercial fundamentals". In the case of a cross-border loan to a borrower in a high-risk jurisdiction, "sound commercial fundamentals" goes beyond looking at a borrower's financial statements, projections and understanding its strategies. The most forward-thinking lenders will strive at the outset of a transaction to understand the full array of leverage points it may have against a borrower and its shareholders, including the need for future financing and/or access to the capital markets, and of the consequences of default for a borrower and its shareholders.

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