

International Business Transactions

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I. Globalization

- A. The Commodification of Goods and Services
- B. What Makes Int'l Business Int'l

II. Lex Mercatoria

- A. Lex Mercatoria
- B. Constraints on National Legal Systems
 - 1. Foreign Sovereign Immunity Doctrine
 - 2. Act of State Doctrine
- C. Choice of Law & Choice of Forum
- D. Arbitration

III. Money, Markets, & Finance

- A. Introduction to Finance
- B. The Markets
 - 1. Central Banks
 - 2. Capital Raising Markets
 - a. Bonds
 - b. Equity
 - 3. Risk management markets
 - a. Foreign Currency
 - b. Derivatives/Commodities

IV. International Contracting & Specific Forms of Transactions

- A. Introduction
- B. Types of Transactions
- C. Three Parts of an International Contract
- D. Three Agreements

V. Payment--Letters of Credit

I. GLOBALIZATION

A. The Commodification of Goods and Services

Globalized Goods and Services

•While globalization has created a world in which virtually no country (even N. Korea) is truly isolated from the trade of foreign goods, there are still some types of goods that we try not to trade or create an expanded market for (drugs, weapons, etc.)

B. What Makes Int'l Business Int'l

Features of International Business Transactions

- Cross border participation.
- Foreign currency.
- Different laws applied across borders.
- Transfer of goods/services across borders.
- Basically, any flow of value across borders.

Foreign Exchange

- Chief concern here is foreign currency--money and finance.
- 90% of all currency transactions are against the U.S. dollar.
- U.S. dollar is the most common “reserve currency.” Two important features of U.S. dollar as reserve currency are:
 - (1) convertability and
 - (2) stability (inflation controlled)
- Foreign exchange market is unique in its efficiency.
- Currency risks in international business transactions include varying rates, inflation, instability, etc.

International Contracts

- Three main features of any contract are
 - (1) explanation of the deal itself; and
 - (2) payment mechanisms for the deals.
 - (3) legal enforcement provisions
- Deciding and ensuring legal enforcement of the contracts is the key role of the lawyer. In ensuring enforceability, lawyer must understand (1) international commercial law and (2) what happens when a dispute ends up in a national court system.

II. LEX MERCATORIA

Reading

- 47-53 (lex merc.)
- 58-65 (lex merc. in specific legal systems)
- 131-99 (Act of State and Foreign Sovereign Immunity)
- 199-261 (choice of law, private choices of law in national courts)

A. Lex Mercatoria

Definition/Characteristics

- Lex mercatoria is the international common law of commerce.
- Definition from reading: “An international body of law, founded on the commercial understandings and contract practices of an international community composed principally of mercantile, shipping, insurance, and banking enterprises of all countries. An autonomous body of law, binding upon national courts.” --Berman.
- LM is international custom in commerce. Lex mercatoria may not be a hard body of written/codified law, but it is evident in contract draftsmanship and expectations of parties (who is going to bear risks, etc.).

History of Lex Mercatoria

- Lex mercatoria is a code of conduct/common law/customary law that preceded codification of practices in national laws.
- Merchants did not have judges or courts to turn to, so they created customary rules of trade. They set up a self regulating/private system to control disputes.
- Features of medieval Lex Mercatoria
 1. It was transitional
 2. Its principal source was mercantile custom
 3. It was administered not by professional judges but by merchants themselves.
 4. Its procedure was speedy and informal
 5. It stressed equity (fairness) as an overriding principal
- Rules were created with an eye toward encouraging the continuing trade/movement of goods. Such a rule was the one holding the opposite of the rule of derivative title. Systematic preference for encouraging the passage of title, even if title is clouded.

Effect of Lex Mercatoria Today

- There are many standardized terms in contracts that are the result of custom/lex mercatoria/etc. which reduces risk, cost, speed in ability to do transaction. There is generally less uncertainty, which results in lower transaction costs.
- Lawyers love transaction costs, because usually the higher they are, the higher the lawyer's payment for services. There is, then, a tension, in that the lawyers' job in international business transactions is to reduce transactions costs, while at the same time increased transactions costs is how you make your money.
- Process of commodification--LM makes services and products more standardized. Ideally, from one similar contract to another the only variance should be price.
- LM also comes in in areas other than contract drafting.

Questions arising under Lex Mercatoria

- Who bears risk of loss?
- Methods of payment

- Security of the goods
- What happens when dispute ends up in a U.S. national court or other national legal system?
(Key question)

What happens when principles of lex mercatoria arise in a national legal system?

- There are serious problems with fitting lex mercatoria into national legal systems. Berman (author of lex mercatoria article) thinks that lex mercatoria should totally override national law, which in reality is impossible. A patchwork of international trade/economic treaties is probably the best that can be hoped for.

- Vimar Seguros Y Reaseguros, S.A. v. M/V Sky Reefer (US) 1995: Supreme Court upheld arbitration clause, allowing dispute to be settled in Japan, even though there was a U.S. law directly on point. Victory for lex mercatoria? Not really, because it took 7 or 8 years before U.S. courts said O.K., you may go to arbitration.

- Berman article pointed out that with regard to the private arrangements between parties:

- (1) LM/international law is not just a body of custom, it a body of separate, defined, international LAW. Treaties are not necessarily the source of this law, he contends, there is the continued custom over time. This runs contrary to the positivist theory of law.

--“Even apart from international conventions, the law governing international commercial transactions--the law merchant--is essentially an international body of law, founded on the commercial understandings and contract practices of an international community composed principally of mercantile, shipping, insurance, and banking enterprises of all countries. It should be seen as an autonomous body of law, binding upon national courts.”

- (2) LM/international law should trump/take precedence over national laws, treaties, etc.

- Why don't national courts simply apply LM? National courts have a hard time applying LM because:

- (1) Rule of (Written) Law: LM has no status of law. Judges' job is to apply the law; if there is no defined law to apply, what is their role in the judiciary system? Quasi-arbitrators? Judges owe their existence to a national legal system, not a fuzzy international customary law.

- (2) Peripheral Transaction Costs: Health, labor, environmental laws are not of much concern to international merchants; they have little or no incentive to care about these things, because all they do is raise transaction costs. There needs to be national laws to control and regulate these third party concerns.

- (3) Contracts: damages, measures of damages, and remedies. Contract law vary very greatly from one national law system to another. Mitigation of damages, for instance, is a requirement in the U.S., but in many other countries and in LM, there is no requirement to mitigate damages. With such profound variations which would greatly change the measure of damages, litigants would be encouraged to forum shop to find the country with contract law that would best aid them in their case.

--To get around this problem, most contracts have liquidated damages clauses which set remedies for breaches and explicitly nullifies any requirement of mitigation of damages.

- (4) Forum shopping: Two concerns: (1) unfairness--it is fundamentally unfair to the other party to do so; and (2) inefficiency--allowing forum shopping leads to uncertainty, which leads to extra contract provisions, which leads to higher transaction costs, which is just bad business.

- Its good to know that in most civil countries, treaties virtually always take precedence over national laws. In the U.S., treaties trump national laws only where there is not a national law directly on point that was enacted after the treaty was implemented.

B. Constraints on National Legal Systems

- Certain rules constrain national legal systems from passing judgement on national sovereigns. Two problems that arise when hauling a sovereign state into your national court:
 - (1) It would be presumptuous for one State to say that they can pass judgement on another State.
 - (2) You are also running a great risk to allow the judiciary branch to act in ways that might affect foreign policy, which is under the purview of the executive branch.
- Two doctrines which limit national legal systems from passing judgment on foreign sovereigns are (1) the foreign sovereign immunity doctrine; and (2) the act of state doctrine.

1. Foreign Sovereign Immunity Doctrine

History of FSIA in United States

- In earliest form, was invoked to allow a ship under a foreign flag to enter U.S. harbors without fear of being held to U.S. laws/jurisdiction.
- Later became an immunity for foreign sovereign entities from U.S. law/jurisdiction when their actions touched U.S. soil, persons, or property.
- Question arose whether the commercial actions of foreign sovereigns should be included under this immunity? U.S. has said no, rejecting the absolute approach and adopting the restrictive approach in 1952 with the “Tate Memorandum.”

Foreign Sovereign Immunities Act

- The Foreign Sovereign Immunity Act of 1976 codified the U.S.’s adoption of the restrictive approach, and went further to add exceptions other than commercial ones.
- The Supreme Court has held that the FSIA provides the sole basis for obtaining jurisdiction over a foreign state in the courts of the U.S., and the only one under which the exceptions to the FSI doctrine can be used. Argentine Republic v. Amerada Hess Shipping Corp. (US) (1989) (finding that the FSIA does not authorize jurisdiction because none of the enumerated exceptions to the Act applied to the facts of this case).

2. Act of State

Definition and Policy

- General Definition: Classically refers to the idea that if when reviewing the acts of a foreign sovereign, those acts of state are considered to be outside the jurisdiction of the courts of the U.S. (or another foreign national system).
- Black letter, classic definition of AOS doctrine (from Kirkpatrick): “U.S. courts will deny jurisdiction when the relief sought or the defense interposed will require a court in the United States to declare invalid the official act of a foreign sovereign performed within its own territory.”
- Exceptions: There are two possible exceptions, noted in *Kirkpatrick*, when a court can ignore the AOS doctrine:
 - (1) Acts of state that consist of commercial transactions
 - (2) Executive branch says that it has no objection to denying the validity of the foreign sovereign act (since the case would be impeding no foreign policy goals) and going forward with the case.W.S. Kirkpatrick & Co. v. Environmental Tectonics Corp. (US) (1990) (finding that AOS doctrine is not applicable because no foreign sovereign act is at issue here).

•Policies underlying the AOS doctrine: international comity, respect for the sovereignty of foreign nations on their own territory, and the avoidance of embarrassment to the Executive Branch in its conduct of foreign relations.

Application to International Business Transactions

- Does all of this matter in real life IBTs? Yes. Despite move toward international privatization, many business entities are still tied up with their governments. Tendency is to separate government actions that are essentially commercial in nature outside of the protections of the AOS doctrine (and the FSI doctrine).
- Key question is what counts as an act of the state, and what is considered the private act of one of the State's officials.

Comparing FSI vs. AOS

- FSI says that the foreign sovereign is not subject to the jurisdiction of a U.S. court. In the U.S., FSI is codified. The most important part of the FSIA is the exceptions to FSI; and the most important of those is the commercial exception.
- AOS doctrine is different in that it is not a bar to jurisdiction. It is not completely codified; it is more of common law rule.
- FSI is a way courts can refuse jurisdiction; AOS, on the other hand, is an affirmative defense against liability that a foreign sovereign can raise.
- AOS is raised far less frequently than FSI, on account of the fact that if FSI is brought up and used, the entire case is thrown out and nothing ever happens. AOS is something that is raised later in a case.
- Usually, if you can raise the AOS defense, FSI probably applies as well.
- This stuff arises in international business transactions when one side of the deal is a foreign sovereign, and when they try to back out of a contract by claiming that the economic exception applies, and they can't be hauled into the court of another nation.
- It also arises more generally when questions regarding lex mercatoria are raised. Those in support of LM would not take FSI as a doctrine to carry much weight, because that would imply that the sovereignty of a state can trump LM. If freedom of contract is really what underlies LM, why should states get treated any different than an individual when the enforcement of a contract is at issue. LM is all about freedom of contract and enforcement of those contracts.

C. Choice of Law & Choice of Forum

Definitions

- Choice of Law: Parties will often put these clauses in their contracts that stipulate what body of law will be applied should a dispute regarding the contract arise.
- Choice of Forum: Another clause often placed in contracts that stipulates which country's legal system will settle the dispute (even if that jurisdiction will not necessarily apply the laws of that jurisdiction).
- Lex mercatoria supporters would prefer that parties be able to contract COL and COF clauses in their contracts. Problem is that courts in most countries do not like:
 - (a) being told that they are going to hear a case, and
 - (b) that they (possibly) are going to apply the law of another country.

Effect of Inserting Such Clauses in International Contracts

- Just because parties add a choice of law or choice of forum clause in their contracts does not necessarily mean that the designated national system will uphold these clauses.

--Certain financial centers, such as NY, HK, London, etc., are often cited in such clauses because they are the most open to accepting these clauses. These cities see it as a way to attract business.

--Anderson sees an increased standardization among these financial centers in what law is applied and how it is applied.

- Relationship to designated forum: NY allows any the parties to any contract (regardless of parties' nationalities) put a choice of law/forum clause in their contract designating NY as their choice. London, Hong Kong, and a few others do the same. Most places/countries, though, require that a reasonable relationship exist between the country and the parties to the contract or the terms of the contract.

- Two issues involved in COL and COF clauses:

- (1) What limits are there on parties' freedom of choice?

- (2) Will the courts force the parties to litigate only in certain forums?

- Probably the most popular way to deal with COL/COF questions in IBTs is to allow one party to chose the forum, and let the other party choosing the law (usually law of a financial center).

Cases

- Midland Bank V. Laker Airways Ltd. (UK) (1986): British court disallowed antitrust suit to be tried in U.S. courts under U.S. antitrust laws because U.S. legal system is repugnant and unjust in its practice of allowing plaintiffs to bring suit with almost no evidence and forcing defendants such as Midland to go through very costly discovery.

- The Bremen v. Zapata Off-Shore Co. (US) (1972):

D. Arbitration

Generally

- When parties include COL and COF clauses, they are not anticipating that a dispute would ever be litigated in one of the designated courts or with the designated law; instead, they are looking to designate places that will enforce an arbitration award (should a dispute have to go to arbitration).

Mechanics of Arbitration

- In most arbitration systems, the arbitrator first tries to negotiate a settlement as part of a mediation, which gets a settlement without placing blame. If the arbitrator(s) cannot facilitate such a resolution, the arbitrator become an arbitrator, acting in judgment of the parties and rendering a decision/award.

- Contracts usually designate one of a few organizations to set up the arbitration, including the International Chamber of Commerce (Paris), the American Association of Arbitration (NY), or some London one. The organizations provide a roster of arbitrators and set up the arbitration; they don't actually do the sanctioning.

Problems with Enforcing Arbitration Awards

- Problem arises when a London company wins a judgment by a Paris arbitration against a North Dakota company. There is a choice of law and choice of forum clause for London in the contract, and an arbitration clause. North Dakota courts will not enforce the arbitration award. So the London company goes to English courts and turns the arbitration award into a court award. At that point, the ND court will most likely accept the English court award/judgment.

- Allendale Mutual Insurance Company v. Bull Data Systems, Inc. (7th Cir.) (1993)

--Doesn't have much to do with arbitration

--Posner, in the Court of Appeals, was basically faced with allowing the case to go forward in the American courts or in the French courts, where a three judge civil court panel of essentially "businessmen" with very little law experience would decide the case. He thought that it should stay in the U.S., fearing that the inexperienced French civil court could not handle the massive amount of documentary evidence and the case.

--Posner granted jurisdiction in the U.S. because there is a U.S. company involved, and because there is not an overwhelming reason to transfer the case to a foreign court.

What Can You Do to Make an Arbitration Agreement Binding

- First, it doesn't matter what you write into the contract unless the State you designate to enforce the agreement respects binding arbitration clauses/agreements.
- Second, make sure that the clause you write says that the agreement will be binding, and the agreement will be enforced in whatever State/district. Good idea to stick to have the big arbitration groups do the arbitrating, and pick a jurisdiction with a big financial center (NY, HK, London, Tokyo, etc.) to enforce the agreement.
- Third, make sure that there will be no de novo review of the agreement.
- Fourth (?), make sure clause comports with NY Convention.

III. MONEY, MARKETS, & FINANCE

Reading

- Honeygold article (sec.II, vol.1, #4)
- Anderson article (sec.II, vol.1, #2)
- Armor Holdings Prospectus
- Weisweiller article
- Futures and options (sec.III, vol.2, #13 & #14)
- Khazakstan project (sec.III, vol.1, #11)

A. Introduction to Finance

- The main thing that makes international business transactions international is the fact that foreign currency is involved. Foreign currency is the main thing that distinguishes domestic business from international business.
- Question is, what capital market can be tapped? Where can a company obtain the capital to finance a deal? In this way, money (and specifically foreign currency) becomes a commodity.
- Three types of markets to be covered:
 - (1) Central Banks
 - (2) Capital Raising Markets
 - a. Bonds
 - b. Equity
 - (3) Risk Management Markets
 - a. Foreign Currency
 - b. Derivatives/Commodities

B. The Markets

1. Central Banks

Generally

- Central banks are the de facto regulators of international commerce.
- How money moves is a coin with two sides:
 - (1) foreign currency markets
 - (2) central banks

Functions of Central Banks

(1) Keeper

- Depository of State's gold, everyone else's gold.
- Holder of "reserve currency"
 - Includes foreign currency--hard currency reserves usually include DM, dollars, Yen, etc.
 - Reserve foreign currencies are held to help foreign trade/hedge against inflation

(2) Issuer of money

- Stable U.S. currency did not form until greenbacks were introduced during Civil War. States thereafter were not allowed to issue their own currency. Formation of central government (often after a civil war) is virtually always accompanied by the formation of a central bank.

(3) Controller of size of money supply

- Sets monetary policy (control of money and credit supply).

--Fiscal policy, on the other hand, concerns the amount of money that the government takes in and doles out.

--Old thinking was that economy could be controlled solely by fiscal policy (government tax collection and spending) (Keynes theory). Lesson from 1930s on is that governments cannot control their countries' economies only by fiscal policy; focus shifted to monetary policy, particularly in 1970s and 80s.

--Stagflation, stagnant economy accompanied by inflation, was something that Keynes did not foresee.

--Reagan's military Keynesianism was the last gasp effort to prove that fiscal policy has a greater effect on the economy than monetary policy. Since then, Greenspan has stepped into the Fed and established monetary policy as the chief controller of the U.S. and world economies.

- Has impact on the availability of credit. Banks extend credit via loans beyond their depository reserves; in this way, the banks "create" money/credit (new credit creates new money).

- Gives central bank/government control over inflation rate.

- Control of money supply is seen today as the only real way to manage individual nations' and the world's economy.

--Truth today, though, is that the foreign currency traders have more control than the central banks. What runs the world today (the flows of currency, capital, credit, etc.) is the foreign currency markets.

(4) Finances the government's debt

- Sells the country's bonds, etc.

- Important because the setting of interest rates are most often based on the interest rate given on government bonds.

(5) Regulates private banking sector for "safety and soundness" (sometimes)

(6) Sets exchange rates for the currency (if it is a currency that does not simply float).

- Also might establish controls on flows of capital (restricts how investment can be put in and taken out of the country).

(7) Sets interest rates

- Leading internal indicator for a country (while foreign exchange rate is the leading external indicator for a country)

(8) Facilitate cross-border payments--Fedwire

Goals of U.S. Central Banking

(1) Price stability: no inflation

(2) Full employment (though full employment fights against price stability because it causes inflation)

- These two goals traditionally fight against each other because you have more money from the full employment chasing a fixed amount of goods because production of goods cannot rise if everyone is already employed. They attempt to alleviate this conflict is centered around finding a way to increase productivity per worker.

Current State of Global Financial Markets vis a vis Central Banks

- Today U.S. dollar is very strong against most all other currencies.

- Interesting thing is that today, each country's individual fiscal policy has a much weaker impact on their economies than their central bank's monetary policy. In turn, the world economy is

much closer to a worldwide regulation because of the interplay between the world's central banks.

- The independence of central banks is essential to their effectiveness.
- Constant struggle between the central banks and the foreign currency markets.

Southeast Asian currency crisis

•Tumbling SE Asian economies:

- | | | | |
|---------------|----------------|-----------------------------------|--------------------------------|
| (1) Thailand | ??? | ??? | Needed to be bailed out by IMF |
| (2) Malaysia | ??? | Ringgit | PM accused currency traders |
| (3) Indonesia | Jakarta Rupiah | Most recent currency/market crash | |

•Malaysian Malaise: Malaysian Prime Minister, amidst a financial market crisis, has proposed that the Malaysian central bank abolish currency trading as a “commodity.” He would allow currency trading only to support trade. Proposal invites interesting questions.

--Problem is that if you place such capital controls on the currency while it is rapidly devaluing in relation to hard currency abroad, the result will be uncontrollable inflation. Inflation is too much money chasing too few goods. When you have inflation everyone wants out of your currency market.

--Capital controls will end up deterring foreign investment.

•What has created the currency crisis in Southeast Asia? There are two theories:

(1) The currency traders are just the “messengers” (Soros’/IMF’s/Western banks’/international currency market’s view):

--Economic fundamentals are down, so the currency traders are pulling out the money before the market bottoms out on its own. The currency traders are messengers of information about the bad news that the economic fundamentals are so low. View is that currency traders are not responsible for the failing currency market, they are just reacting to a failing market.

--The value of the asset is its present value based on the cash flow that it will produce in the future.

--In a “tiger” market where credit is cheap, there is a huge flow of capital into the country, and there is a need for a place to invest some of that excess money, it will most likely go into real estate. Commercial real estate absorbs lots of money and produces high returns. As a general rule, a country that runs into problems in the real estate sector will result in the currency and the economy nosediving. The SE Asian currency crisis, which is a reflection of a poor economic indicators, will (and has been) result in a much less generous extension of credit.

(2) Leverage is driving down the currency (Prime Minister’s view):

--There is a vicious cycle of people selling off the currency that is more of a conspiracy to drive the currency down than it is a reflection of current economic indicators. Argues that the currency is sliding further and further because there is a cycle of selling currency, which results in economic indicators dropping, which results in selling currency, which results in indicators dropping, etc., etc., etc.

(*) Anderson’s view

--His view is that first argument is 80% of it, and latter argument is 20% of it. Most currency traders would agree that the SE Asian currencies are currently undervalued. They are not being purchased, and people are not betting long on the currency, because there is still the threat that the government is going to impose significant capital controls on the currency, which would prevent a floating rate that freely reflected the true level of the country’s economic indicators.

2. Capital Raising Markets

Generally

- International financial/capital markets are one of the things that central banks regulate. Capital is not money for consumption, it is money used to create assets. They produce vertical flows of money (amassing of money to run a business).
- Types of securities markets
 - Primary market--initial offering of securities
 - Secondary market--subsequent trading of those securities
 - Primary markets are the initial sale, primary issuance of a security into the marketplace. Secondary market is the trading of the securities/financial instruments in the market.

Primary Markets--The Underwriting Process (for debt or equity)

- (1) Company in search of capital first calls their bankers, specifically their investment bankers.
 - Investment bankers play the critical role of intermediary between the companies and the millions of people who have money to invest. The investment companies' role is called underwriting.
 - Investment banks are really players in the securities markets for stocks and bonds.
 - There is a coming erosion of the difference between commercial banking and investment banking. In the U.S., the Glass-Steagall act prohibits banks from offering securities, and investment banks from conducting traditional banking. This is mandated because there is a national interest in making sure that commercial banks are extremely stable, which the securities business inherently is not. Also, bank deposits are insured by FDIC; it would be impossible to grant such insurance to investment banks.
 - Erosion has begun with people like Citibank entering the underwriting business; the key is that the money that is backing the underwriting (paying for the securities) is not people's commercial deposits (not the money that is FDIC insured).
- (2) Investment bank, in conjunction with the company, must decide whether to issue stocks or bonds. The company must consider entering an absolute debt obligation or giving up control (dilution).
 - Company must consider, basically, how they are going to rent money/capital from investors. They first give either a piece of the company or the principle back to the investor; the second consideration determines what is the better deal: is it cheaper to sell bonds that they have to pay X interest, or is it better to sell stock that will require the payment of X dividends.
 - Investment bankers, underwriter's counsel, the issuer, and issuer's counsel all work together to decide (1) which type of contract/type of paper will be offered, and (2) how the deal will be affected by the country's securities regulators. Securities regulators are there to ensure full and fair disclosure, not to pass judgment on the investment.
 - Main role of investment company is to distribute the securities. Two critical things related to this distribution:
 - (1) Investment banks can merely be a distributor of someone else's product at no risk to itself--"best efforts underwriting." No guaranty that bank will purchase the securities at a certain price. Company bears the risk.
 - (2) Investment bank is buying and purchasing for its own account the entire offering--"firm commitment underwriting." By far the most common form of underwriting for large issues. Company bears no risk. They are guaranteed to get the full cost of the offering immediately at the time of closing. Bank plays classic role of an intermediate

distributor. They pay for the securities, hold them for a nanosecond, then sell it down the distribution line (to broker-dealers) for a premium.

--Investment bankers are paid so much more money than issuers' lawyers or underwriters' lawyers because of one main reason: they are tasked with setting the price of the offering. Setting the offering too high or too low will kill an offering; investment bank will either be stuck with the securities if they are priced too high, or they may sell everything immediately but not make as much as they could have if the securities are priced too low.

--Large and often medium "firm commitment" underwritings contain so much risk that usually more than one underwriter is necessary. There is an "underwriting syndicate" that share the risk. Each underwriter gets a certain percentage of the total securities offered, then each underwriter has to find broker/dealers to pass them off to. Often broker/dealers take the securities on consignment, merely selling what they can for the one of the investment banks on the underwriting syndicate.

(3) In the U.S. this process is used for all equity offerings, issuance of corporate debt, and the issuance of foreign debt in the U.S. U.S. government issued debt does not go through the same process. They are offered at auction, then traded in the secondary markets.

U.S. Securities Regulation

- Registration statements/prospectuses are almost entirely regulated by U.S. securities law.
- Can't sell any securities in U.S. unless they are preceded by a registration statement/prospectus that is approved by the SEC.
- Prospectus is
 - (1) a selling/advertising document, and
 - (2) a disclosure document.
- Registration statement is not intended by SEC to show that the offering is necessarily a "good buy," it is intended to ensure transparency and disclosure of information to all potential buyers. Such disclosure makes the U.S. securities system:
 - (*) stable
 - (1) fair--level playing field for all investors
 - (2) efficient--keeps level of liquidity in the market high
- Because of this high level of regulation, the U.S. is known as having the most liquid capital markets in the world (high levels of money transacted, low transaction costs, etc.)

a. Bonds

Bond Markets Generally

- Key feature of bonds is fixed income. Fixed return of interest is received in return for lending of money.
- Types of debt/bonds
 - (1) Sovereign debt--bonds sold by state governments. Creates primary and secondary markets.
 - (2) Corporate debt --debt issued by private companies. Creates primary and secondary markets. Lender is the bond purchasers/holders of the bonds. Corporations are the issuers of the debt/bonds.
- Difference between the two types of bond markets: as foreign sovereign debt rises, ability of corporations to issue debt decreases, because there is less money available to be invested; too much debt is tied up in State bonds.

The Global Bond Market

- The world's key bond markets are located in NY, London, Tokyo, Singapore, Frankfurt, Amsterdam, Zurich and Hong Kong (kinda). These are the cities in which most bonds are issued. Each of the cities' countries' laws regulate the bonds. In that way, there is no true global bond market. They are more global than equities markets, but they are less global than currency markets.

Foreign Bonds v. Euro Bonds

- Foreign bonds** are bonds that are issued by foreign borrowers in a nation's domestic capital market and are usually denominated in the nation's domestic currency.

- What makes foreign bonds different from ordinary domestic bonds is that countries typically make legal distinctions between bonds issued by domestic residents and bonds issued by foreigners (tax laws, regulations on timing or amount of bonds that may be issued, requirements as to type of amount of information that borrower has to disclose prior to bond issue, registration requirements, restrictions on who can buy the bonds, etc.).

- Eurobonds** differ from foreign bonds in that eurobonds denominated in a particular currency are usually issued simultaneously in the capital markets of several nations. Has no necessary connection to Europe; "euro" here means international. Eurobonds are vastly less regulated bonds because regulators are not worried about protecting their own citizens; the bonds are issued in many other places under a different currency.

Eurobonds

- Regulatory and tax matters regarding eurobonds

- There is a difference between bearer bonds (whoever holds the bond owns it) and registered bonds (registered records of owners). Bearer bonds are intimately related to tax evasion because they can be held without disclosing name, nationality, etc. The U.S. places very high taxes on U.S. citizens who hold bearer bonds. They make it very attractive to hold only registered bonds.

- Eurobonds are generally issued on a tax-paid/gross-up basis. The tax on the interest that you receive are paid by the issuer, not by the holder. Therefore, it appears that eurobonds are tax free bonds.

- Eurocredits v. eurobonds

- With eurobonds, you have no right to have a say in the issuing company unless they default on interest payments. Eurocredits, however, gives you power to view financial payments, etc. of the company to make sure that your investment is still a good one. Eurocredits, therefore, are used when there is more worry about the financial health of the issuing company; Eurobonds are purchased when the issuing company is pretty stable/secure.

- Types of Eurobonds

- (1) Straight eurobonds: vanilla or plain vanilla eurobond.

- Pays interest plus some percentage of principle on an annual basis. Most straightforward type of loan (like a 30-year fixed mortgage). Typically domestic bonds are paid every six months; because eurobond interest must be paid to holders worldwide, they are paid annually to save costs.

- (2) Floating Rate Notes (FRNs)

- Just like straight eurobonds, but the maturity is much shorter (shorter term indebtedness).

- Interest rate floats (just like an adjustable-rate mortgage). Floats usually along the LIBOR (London Interbank Offering Rate) rate plus a certain percentage. In U.S., usually pegged to Fed rate. Because margins earned by issuers is growing more competitive, the percentage of interest charged above LIBOR has become more and more narrow.

Percentages have been narrowed to fractions of a percentage, which have been narrowed to “basis points.” Basis points are thousandths of a percentage point (35 basis points above LIBOR=LIBOR plus .35%(?)).

(3) Zero Coupon Bonds (aka zeros)

--Instead of paying 1000 for a 1000 bond, then receiving interest on the bond, you pay 500 for a 1000 bond, hold it for a certain amount of time, then get 1000. You pay a discount at the beginning to get an increased amount on the other end. The gap between the cost and the return (the spread) is how much you would have earned with interest.

--Original issue discount.

--Zeros are popular because you avoid some tax implications. There are some actually economic reasons on the issuers side because some transaction costs are avoided.

--Very, very popular. Used as both short term and long term debt.

(4) Convertible Bonds

--Bonds which begin their life as a bond, but may be converted into another type of the company's securities. Bond contract allows, under certain defined circumstances, the holder to convert the bond into another type of security, usually common stock. You would convert if the company was doing so well and had such potential to do well that you foresaw earning a greater return on common stock increasing in value than you would on the steady/fixed rate of interest.

--There is a fixed conversion price in the contract (starts looking like an option).

Extremely popular because the purchase of a bond with a converted future costs the company less; they can offer lower interest because they are offering added value in the option to conversion.

--When you convert, the amount of principle still due to you is put toward the cost of stock. The cost of the stock you may purchase is usually the current market price minus a certain percentage of its value (a nice bonus for the bond holder/converter). Typically the type of company's stock is predetermined; you can only purchase the type of stock that is designated in the contract.

(5) Dual Currency Bonds

--Very risky and dangerous.

--The borrowing is made in one currency, but the interest, principle, or both are paid in another currency. Puts on both parties the burden of making predictions as to how the currency rates might move against each other. They are typically paying principle and interest annually.

--Mortgage backed securities have become increasingly popular in fairly stable industrial countries. The many banks that extend mortgage loans sell the right to receive the payments of those loans from the many banks. The mortgages are pooled by a greater entity. That greater entity then sells bonds that are backed by the relatively steady flow of income on all those mortgages. (does this have anything to do with dual currency bonds?)

•U.S. Regulation of Eurobonds: U.S. does not fundamentally attempt to regulate eurobonds as long as they are not sold to U.S. investors. Three rules:

(1) Can't sell eurobonds to U.S. investors in the initial sale. Must be seasoned in market for at least 90 days.

(2) Private placement exemption: Rule 144 market. Can sell eurobonds to U.S. persons if they fall in the private placement exemptions. Those exemptions center around the fact that the investors are sophisticated (they can protect themselves).

(3) Bearer bonds tax rule: unique to U.S. You can't sell bearer bonds to U.S. persons because the tax that they would have to pay is outrageous.

b. Equity

Global Equities Market?

- There is not really much of a global equities market, because each market is governed by state corporate law.
- Bonds are a much more developed financial international market than equities markets; they can be traded anywhere by anyone.
- Another reason bond markets are more international is because they are governed largely by contract law and in turn *lex mercatoria*; equities markets are governed by local state laws and regulations and they are not contractual in nature.
- Agency and fiduciary duty law govern equities. Board of directors make the decisions that impact the return that you will get on your investment.
- Global depository receipts (GDRs) are pieces of paper that show that you own a security so that it can be traded on many different markets. Anderson's prediction is that the trading of GDRs will in the future be much more important than the trading of actual shares on the main stock exchange.

Global Depository Receipts/American Depository Receipts

- Most important move toward internationalization of stocks has been the movement toward Global Depository Receipts (GDRs)/American Depository Receipts (ADRs). They are a legal mechanism whereby a foreign corporation can make its stock available to U.S. investors.
- It is very difficult for foreign corporations to enter the U.S. capital markets because of the foreign currency concerns, cost of making the offering, cost of period disclosures required by Exchange Act, cost of continuously living up to U.S. accounting standards, etc. The accounting burden in particular is often the main factor that keeps foreign companies from listing in the U.S.
- One way foreign companies access U.S. markets without going public is by engaging in private placements. Problem is that often this limits your investor pool (to sophisticated investors).

American Depository Receipts--Generally

- ADRs are used by foreign companies who want to raise capital in the U.S. capital markets without registering with the SEC and going through the web of U.S. securities regulations.
- Two main reasons foreign companies do not want to be listed on U.S. exchanges:
 - (1) do not want to make the disclosures that the SEC requires (particularly re primary investors and shareholders),
 - (2) and they don't want to conform to the U.S. accounting requirements.
- This problem goes the other ways at times, too, with people not wanting to deal with the securities regs in Tokyo or somewhere else.
- Under such a situation, the trust must provide certain accounting and other information regarding the foreign company, but not nearly as much as is required if the foreign company was listed on a U.S. market.
- The ADR is a U.S. security. It is not a stock, but it is a security. It is a receipt that confers the rights to receive dividends and income from the underlying foreign security.

American Depository Receipts--Mechanics

- ADRs provide a method by which a foreign company/issuer of stock can get access to U.S. capital markets in an indirect form.

- The foreign company issues stock in its own country. An intermediary company creates an ADR facility (usually a U.S. bank or investment company), which will purchase the non-U.S. shares and deposit them into the facility (usually in the legal form of a trust). The facility/trust is usually on U.S. shores (NY). The facility is the owner of record, so they get the dividends. The facility then issues U.S. securities called ADRs. The ADR represents a security with the mirror rights & obligations of the original security.
- The facility is intended to be a pass-through. It is not a complete match, in that it is a U.S. security that at the end of the day reflects the facility, not the original company.
- The ADR basically passes on the benefit that the original security provides to them (minus a commission).
- The ADR allows investors to, in essence, hold foreign issued stocks without going through the hassles that accompanies holding such a security. Drawback is you won't get the amount of disclosure that a U.S. issuer would be forced to provide.
- The ADR's value fluctuates with the value of the underlying security, but it the value of the ADR also reflects changes in the foreign exchange markets and the ADR facility discount which might vary depending upon the information or lack of information it receives from the foreign issuer.
- Some ADR programs allow the holders to vote the shares, others do not.
- Countries other than the U.S. have similar types of depository receipt systems that allow its citizens to hold foreign issued stocks without going through the foreign country's regulations.

Dilution

- Dilution concerns control of company from the viewpoint of those who owned stock in the company before this issuance. They want to keep a constant percentage of control in the company before and after the issuance of new stock.
- Authorized shares. Treasury shares. Must look at stock options held, because when those options are exercised, the shares are likely to come from the treasury shares, which will increase the issued shares and dilute the ownership share of existing shareholders. When you are considering whether to invest, you want to make sure that there are not too many stock options or treasury shares, because that means that the share you buy today could end up representing a much smaller share in the company than it represents when you first buy them.
- Stock options are used primarily to control the loyalty of insiders.

3. Risk management markets

Generally

- Function of derivatives market, foreign currency market, etc., is risk management. Risk is spread horizontally among financial players. They are not about raising money, as with capital markets; they are about shifting risks.
- For example, in a deal a corporation pays a third party a fee to assume the risk of fluctuations in the foreign currency market (currency rate swap).
- Three basic terms in risk management:
 - (1) Speculation--gambling. Taking a position that you hope will bring big returns.
 - (2) Hedging--making an investment in the opposite direction of what you are speculating upon. An offsetting position that will reduce the risk of your speculative position.
 - (3) Arbitraging--the simultaneous purchase and sale of exactly the same good for different prices in different markets or goods sharing exactly the same risks, so that your net ends up being zero. You capture the spread and lose the spread.

- When engaging in a international commercial transaction, companies will hedge risk by purchasing a type of insurance. They pay a premium to receive a guarantee on the currency or interest rate. The insurer purchases the currency or interest risk because they are smart enough to know what to do with it.

Random Terms

- Spot market/spot rate: related to time. spot rate means the price now.
- Spread: gap between buying price and selling price.

a. Foreign Currency

Foreign Exchange Markets (Forex)

- Companies enter the forex markets more for risk management than for investment purposes. Foreign exchange is intimately related to the idea of hedging risk. A byproduct of this hedging of risk is an opportunity for companies to speculate on that risk--gambling on that risk.
- Basic principles:
 - (1) If a business transaction involving money has been concluded between residents of different currency areas, it necessarily involves a foreign exchange deal.
 - (2) A foreign exchange deal is merely an exchanging of one currency or national money for another.
- Four reasons why parties enter into forex transactions:
 - (1) Hedging risk
 - (2) Commercial reasons--anywhere where trade, commerce, and money cross borders, forex must be considered. Transactions that are taking place outside of financial markets (regular buying and selling of goods and services).
 - (3) Interest arbitrage
 - Arbitrage is simultaneously buying and selling something that has the same value but different prices in different markets, so you capture the spread between them.
 - Interest arbitrage is when banks and large financial institutions shift money overnight to overseas markets where it earns interest overnight, then returns to your bank in the morning. With such movement, there is currency risk and interest risk. The transaction becomes risk free by entering into futures contracts to cover both the currency risk and the interest risk.
 - Effect of bunch of people entering the arbitrage business is the narrowing of the difference between interest rates. The spread narrows as the difference in interest rates from one country to the next narrows.
 - (4) Speculation
 - Speculation is the desire to buy what one does not need, but hopes later to sell at a profit to those who do; or the desire to sell for future delivery what one does not have or expect to have, but hopes to buy at a lower price before one has to deliver it.
 - Hedge funds hedge or leverage. Speculation increases the amount of liquidity in the market. Speculation is a good thing.
 - Hot money is a category of speculation that is closely related to interest arbitrage and is a large part of the market. It is overnight funds where the currency risk is not hedged (changes in currency is gambled upon).

b. Derivatives/Commodities

Commodities Markets

- Anything can be made into a commodity (gold, oil, bananas). Within the last 10 years commodities have taken off with indexing. Goldman Sachs and others create indexes of oil or gold or whatever.
- Playing the commodities markets is very very dangerous because you lose money over and over with the hope of striking it huge once.
- Foreign currency is a commodity market like any other.
- Financial instruments bonds, futures, forwards, etc. can be traded as commodities, too. Heaviest trading on Chicago markets is no longer pork bellies, grain, etc.; it is financial instruments. There are markets for financial futures (interest rate futures).
- People go into commodity markets to hedge risks they have. Commodity markets are used to large extent to hedge various risks parties can have. (i.e.) Foreign currency is one kind of risk; foreign currency is a commodity.
 - Foreign currency risks hedged on commodity market known as the foreign currency market.
 - Example: maker of swatch watches goes into foreign currency market to push foreign currency risk on someone else. Swatch watch maker deals with every other risk except currency risks. maker of swatches is paying another a premium to take risk on and then maker deals with what he is best at: all other risks.

Derivatives markets

- A derivative is an instrument, the value of which depend upon the value of some other financial instrument.
- For example, an option to purchase stock is a derivative instrument because the value of the option depends on the value of the stock the option entitles one to buy.
- Primary function of derivatives markets is the management of risk. Capital market is vertical, commodities market is more or less vertical, but derivatives market are not.
- Derivatives market involves risks that you don't want to take and allowing someone else to take on the risk. The need for this has exploded since the currency market opened up (going from being fixed to floating?).
- These instruments enable parties to shift risks from one to another, ideally matching risks to parties in ways that reduce risk in the system overall. Currency rate risk and interest rate risk are two of the variable most eagerly sought to be controlled.
- Leverage: Derivatives' cost efficiencies in hedging risks are by definition "leverage"--a small amount of capital commanding a large position. But leverage is always a two-edged sword: it can be used equally to hedge and reduce risks, or to speculate and deliberately increase them.
- Examples of derivatives include:
 - (1) Forwards/Futures: instrument that allows you to establish a price now for some date in the future.
 - (2) Options: premium paid for a right that you don't have to do anything with.
 - (3) Swaps

Futures/Forward-Based Derivatives

- A forward contract enables its buyer to lock in today the future price of an asset, be it a currency, an interest rate, an equity, or a commodity. As a hedging device, the purchaser gives up the possibility that prices in the future will go up in order to avoid the risk that they might fall; the forward reduces variance in both directions, up and down.
- Example: If you are a farmer, you are running to basic risks. One, that your crop will fail and you will have nothing to bring to market. Two, that you and everyone else will have bumper

crops, you will bring your crop to market, but the market price will have plummeted. To hedge against the first risk, the only thing you can really do is buy insurance. To hedge against the second risk, however, you would enter a forward/future contract before the crop season to lock in a price for future delivery of your crop on a determined date. That way, you know that you will get a certain amount of money. If prices drop, you'll still get your money. If prices rise, you will just lose out on the extra profit (but that's the price you pay to avoid risk of prices dropping).

- Difference between a forward and a future: Future is a forward contract that has standardized contract terms and is traded on a recognized exchange.

- Standard Terms: All terms of a futures contract are the same (they are standardized by the exchange) except for the price and the date. This increases liquidity, confidence in the market, etc.

- Three types of exchange:

- (1) *No guarantor relationship*. The exchange is simply the place where someone else comes to sell and another person comes to buy. Exchange just brings the people together, it does not guarantee the contract in any way.

- (2) *Guarantor*. Here the exchange plays the role of the guarantor as well.

- (3) *Exchange as primary settlor*. when the buyer does not even know the seller, where the exchange itself is the settler of the contract. There is enough liquidity in the market to make sure that the market is sufficiently capitalized to take care of all buy and sell orders.

- The futures markets are not just made up of two players (hedgers & speculators) who just constantly bet against each other. Note, though, that hedgers often bet against each other, particularly when they have opposite risks to hedge against. A farmer and a baker, for instance would hedge against the opposite risks of the cost of flour being too high or too low.

- Swap contract: type of forward-based derivative; an agreement between two parties to exchange (two different types of) cash flows through the life of a contract. Most popular swaps are interest rate swaps and currency rate swaps.

Options

- Purchase option is a right to purchase property, at a fixed price, on a specific date or during a specific duration. It's a right, but not an obligation. There is again a purchaser and a seller, but they do not have the symmetrical obligations that they do with futures.

- Purchaser pays a premium for the right to purchase the property.

- Most difficult question is how you value the cost of options. The Black-Scholes (Merton) formula for pricing options revolutionized the options market and the financial markets generally. Formula was great, but up until about 20 years ago, there was no way to easily compute it because calculators were not sophisticated enough.

- Options are so important in today's world because they are such a valuable form of insurance. When you go and buy an option.

- What is difference between future and option?: With a future, both parties are committed to delivering at some point in future. With an option, there is an option to purchase. You pay a premium to someone for option of not having to deliver if you don't want to; premium for privilege make decision.

Kazak Oil Project

- Factors to consider in virtually any deal: Risk, Return, Control, Duration.

- Kazak oil company wanted maximum amount of inbound investment, and minimum loss of control.

- Investors want the maximum amount of return, with the minimum amount of risk. In short, they want liquidity. They will not really get it, though, because the money they are investing is going to go immediately toward the cost of capital improvements, machinery, etc. The resulting illiquidity means much higher risk.
- In return for the shouldering this risk, the investors will ask in return for greater control.
- Capital structure: partly privatized; share interests; joint venture.
- Investors the equivalent of a venture capitalists who actually go in and exert control over the company.
- Investor group is probably going to be comprised completely of oil & gas companies, who have experience in the business.
- If you want to structure the deal to make sure you can take your money and run when you want, you would probably want to go to the U.S. capital markets.
- Two big problems with this type of deal: if you can't prove that entity will be profitable, you aren't going to get investors; and second, no amount of financial/legal wrangling can cover up the fact that a venture will not be a liquid one.
 - Investor group sought to make investment liquid.
 - Most important requirement if investors want to get out is profitability. Unless venture profitable, no amount of financial genius will turn a bad idea into a good idea. If not profitable no one will buy.
- When governments privatize a business, they are looking for two things: an influx of money, and better management of the entity.

IV. INTERNATIONAL CONTRACTING & SPECIFIC FORMS OF TRANSACTIONS

Reading

- Heroic Newspaper Project
- Cook/Anderson Agreement
- RZB Revolving Credit Loan Agreement
- MDLF Model Loan Agreement

A. Introduction

Shifting Focus From Int'l Financial Markets to Int'l Contracting

- There are three types of flows related to international business transactions:
 - (1) Vertical flows: the idea that funds are flowing vertically and tapped either into bond or stock market.
 - (2) Hedging/risk flows: using commodities and derivatives markets to manage risk.
 - (3) Horizontal flows: transactions between companies. Companies are commercial entities. In other words, horizontal flows are commercial transactions involving payments.
- There is more to international business than just the international financial markets (first and second flows). Another significant aspect is the system of payments between companies for goods, services, etc. (horizontal flows/transactions).
- We're interested less in the law of international trade (WTO, GATT, NAFTA, etc.), and more on the transfer of money and credit as payment mechanisms. Two types of transactions:
 - (1) Money used to pay for things (cash)
 - (2) Credit used to finance transactions (bank guarantees, letters of credit, etc.). Much greater emphasis from a legal aspect on this type of transaction because a promise to pay is something that must be structured as a contract and governed by some form of law.

B. Types of Transactions

Examples of international commercial transactions

- (1) **Cash Transaction**--Simplest example of international commercial transaction.
 - Example: Anderson in Prague. Walked into tourist shop. Asked for a swatch watch. Vendor quoted him a price in Swiss francs. Vendor converted price into US dollars. Vendor handed Anderson watch, Anderson handed owner US dollars.
 - This transaction has every element of commercial transaction: Had to do foreign exchange transaction, buying and selling. Note however that there was no contract. Only documentation of transaction is a receipt.
- (2) **Invoice Payment Transaction**
 - Anderson sitting in NY. He decides want to sell Swiss watches. Swatch sound great. How would he get Swatch watches (assume no swatches in US)? An importer, exporter? Assume Anderson goes to Switzerland. He puts in an order. When producer ready to send watches he calls Anderson.
 - Key point added into this is that no longer just exchanging value. Here, Anderson is in position where he is asking producer to commit to producing and Anderson committing to pay for watches--*adding risks*: people promising to do something.
 - Thus, invoice payments add risks. Producer takes risk thath if he sends watches, how does he know buyer will uphold his end of the bargain?
- (3) **Lending Transaction**--Move to a transaction where credit risk not a side effect (as in example two, delivery of commodity), but *credit whole point to transaction*.

- Lending Transaction: loan where entire transaction is about credit. Point of transaction is to extend credit.
- See loan agreement documents--Sec.II, Vol.II assignments 7 (RZB draft loan agreement) and 8 (MDLF loan agreement. These are the documents one would ask for to ensure they are going to get re-paid if engaged in a lending transaction.

B. Three Parts of an International Contract

Three Parts of Contracts (from the drafting lawyer's perspective)

(1) **The Business Deal**: description which reflects what the parties, as business parties, feel that they are doing. Lawyer must put down on paper an accurate reflection of what parties want to do. Lawyer writes provisions describing deal from the business perspective.

--For this section, lawyer acts as scribe.

--Article I, sections 1.1, 1.2, and 1.3 purport to tell you much of the stuff that is in the promissory note.

--Sec. 1.4. Optional Pre-payment (p221)--no legal obligation to put this in, but it here was negotiated.

(2) **Legal Enforcement Provisions**: lawyer writes provisions that make sure the business deal is enforceable, including choice of law and arbitration provisions. Client usually takes very little part in this section. Client only cares later, and only if there is a problem which requires legal remedies.

--Lawyer puts in these boilerplate legal provisions to protect the legal enforceability of the business deal.

--If the lawyer does not put in the needed provisions in this part, he is opening himself up to malpractice. Client doesn't really care about these provisions until something goes wrong.

(3) **Business Protections Provisions**: provisions that make sure business deal cannot be changed directly or indirectly. Example provision is that "party who is borrower cannot change its line of business without permission of lender."

--Lawyer puts in these business provisions to protect the deal economically.

--Goal in this case is to prevent editors from siphoning off the value that should go as dividends to EC and then back as re-payment to MDLF.

--See Sec. 4.4. (p.225). See also Sec. 3.11, which is a provision that says that because EC has received value from MDLF and because that needs to be repaid, the editors may not change their line of business without permission from MDLF.

Summary

•Point is that lenders have a great deal to worry about when they lend venture capital, and they need a way to protect themselves such as the last clause listed above. They need to worry because the borrower sees the money as new, fresh, borrowed money with which they can take a risk.

•If the borrower thinks he can take a change, change business, and make more money, he will do it. Borrower has everything to gain, while bank has everything to lose.

The Loan Documents

(1) **Loan Agreement**: contract that describes the relation between the parties--MDLF and EC.

(2) **Promissory Note**: promise to pay. See exhibit A on page 235 of sec.II, vol.II. Promissory Note describes how much money is being loaned, the interest rate, the repayment schedule, and the duration of the loan.

(3) **Guaranty:** does not have to be in every transaction, but there is one in this transaction. Guarantee is between third party shareholder in favor of MDLF.

D. Three Agreements

•Three agreements described below are:

- (1) Service Contract Cook/Anderson Agreement
- (2) Loan Agreement MDLF Agreement
- (3) Revolving Credit Agmt RZB Agreement

(1) Cook/Anderson Service Agreement

- Cook is in France; Anderson is in US. Its an agreement whereby Cook promises to provide services to Anderson in return for Anderson's cash. The currency of the contract is US dollars.
- Form of contract is quite traditional. Lists parties, then definitions, then a statement of the deal under the subheading "Services." Deal is not actually stated there, it is cross-referenced in the definition section and/or an attachment/annex/appendix/schedule; deal is actually located in schedules one and two.
- There is also a section that allows Cook to subcontract.
- Next section gives the fee schedule reflecting Anderson's payment for Cook's services. Anderson is to be billed in arrears, after the month during which the service is provided.
- Section 3.3 obligates Anderson to also pay Cook's out of pocket expenses. What constitutes an "out of pocket" expense is a good question, a question that is not addressed in the text or in the definitions.
- Section 3.4 places the burden of paying taxes on Anderson. Anderson agreed to pay Cook on a "gross up basis," which is the regular payment plus whatever is needed to cover taxes. Anderson does not have to pay Cook's income taxes; it agrees to pay import taxes, etc.
- Penalties against Anderson are mentioned.
- Upon premature termination of the agreement, Cook gets proportional payment.
- Section on Variations.
- Section on customer responsibilities--customer ends up warranting that the information provided to Cook has been researched.
- Confidentiality clause--pretty standard.
- Consents section--says that if Cook cannot perform the services because Anderson can't get the proper consents, the whole deal is off (but Cook still gets some money for costs already paid).
- Warranties & Representations section. Sometimes called Recitals. Parties warrant that you have the legal authority to enter such a contract, that you are legal incorporated somewhere, that you are legally registered somewhere (and are in good standing, etc.), that the persons signing the contract are duly authorized to do so, that it is authorized to do the type of business it is doing, that they are going to perform the contract, that all statements are true, etc. Might ask for actual documents proving that you are in good standing or for opinion letters from a law firm (which is intended to shift liability over to the lawyers' insurance provider).
- Liability section
- Term and termination section--circumstances under which it OK for one party or the other to get out of the contract. Usually there are two issues regarding termination: (1) Voluntary termination (non-fault termination); and (2) Fault or breach. The latter is the more complicated part of the contract; it usually includes a big section on "events of default," such as not paying a bill, or not providing services.
- Item 12--non-solicitation agreement promises that you will not hire away any of the other side's people or subcontractors.

- Series of routine provisions:
 - Force majeure clause--not responsible for an act of nature.
 - Legal compliance--part of force majeure.
 - Notices--must have a place where service of process will be accepted.
 - Assignment--says whether you can transfer the rights and/or obligations of the contract to a third party. Usually assignment is allowed contingent on the other party's agreement.
- Another series of routine contract law provisions:
- Choice of forum/choice of law is France (?).

(2) MDLF Loan Agreement/Heroic Newspaper Hypothetical

- Facts:
 - Heroic Newspaper ("HN") owned by three entities: government (30%); evil Mafia guy (40%); and good Mafia guy (30%).
 - Editorial board wants to gain control of paper. Evil Mafia guy wants to run for president of Slovakia and wants to use paper as his vehicle for election, so he wants to stick around, but editors and government want him out.
 - We have to find a way for editorial board to gain control of paper so paper will become an unbiased publication. Why do editors want government out? Because government does not like the paper and will not all criticism of government to be printed if they own 40% of the paper. Government is willing to sell its stake because at this point it is more interested in the cash. Don't mind so much if good Mafia guy stays.
- Problem: how does MDLF put money into HN in order to get rid of government (40%) and bad gangster (30%)? Editors want to take over the 70% stake by getting loan from MDLF, and allow a good gangster, who already owns 30%, to keep his share. We also want to make sure MDLF gets its loan repaid. We can do this by finding a way to make sure MDLF shares in HN's profits, when they come around.
- Options that allow editorial board to gain control:
 - (1) MDLF loans money to HN, which buys 70% of shares.
 - Concern that in one way obvious solution is to lend money to group of editors and they can turn around and buy shares from government and other guys. However, editors not a very good credit risk--no collateral, no assets to repay.
 - Need solution not just how to buy shares, but also need security for lender.
 - (2) Maybe there is some way to lend to company not editors, because of the sole fact that the editors have no collateral.
 - The newspaper company has assets: Printing presses, physical assets like its building; intangible assets like name, reputation of paper, goodwill of sales. Company sells papers and has cash flowing through newspaper company. This money ends up being an asset. Thus, have financial assets in company. If manage a way to lend money to paper, can find a way to get security interest on their future sales.
 - Way to get security interest on their future sales is to make a contract and in contract specify: if paper can't pay loan payments, paper will extend cash flow gathered from sale of papers to lender. Note: lender doesn't want to have to attach sales. Lender would like corporation to make loan payments. But if corporation defaults, need something to grab onto.
 - There is one problem if lender lends to company. It is difficult to assure money won't be absorbed into company, i.e. be used as a dividend. Want money to be used to buy other shares so as to squeeze out Mafia control.
 - (3) Best option: Form an entity where board becomes trustees of money.

These are the facts: News company--gangster 1 (40%); gangster 2 (30%); government (30%).

Thus, first have editors form an editor company. Editors company will divide its shares between selves (editors). Owners of Editors Company are editors individually.

Then have off shore bank (MDLF) that will loan money. MDLF will loan to editors company. Editors company will pay cash for 70% holding in paper (Mafia's shares). Thus, editors offer cash and take back stock and thus majority of shares (controlling block) owned by editors. *Still have a credit risk problem.* What does lender do?

(i) Take security interest in stock itself. If editors default on payment first thing seized is stock of news company. Thus what lender is putting stock in escrow for security. However we want to avoid this. Can MDLF get control of the papers assets instead of stock. Would need permission of government, but permission will likely be granted because government wants mafia out and offered guarantee.

(ii) Guarantee. Facts, government is offering guarantee. Government hates mafia and wants them out. Guarantees loan taken by Editors company. IN other words, guarantee is government. In this instance government hates mafia. Does not want to be in company with Mafia. Thus government guarantees that it will pay loan payment if Editors Company defaults. This is a real sweeter in MBLF's eyes.

- Good gangster, who owns the other 30% of HN and is very wealthy, guarantees the loan, promising that if EC does not repay the loan, he will.
- The loan is also backed up with collateral of the editors who own EC, such as cars, houses, etc.
- Problem is that even though there are these guarantees, the primary asset of EC is the 70% interest in HN. Therefore, if EC defaulted on the loan, MDLF could very well go after the stake in HN, rather than the gangster's guarantee or the editors' personal assets.
- Another problem is the potential that editors/shareholders in EC are stupid, and when HN does well they decide to capture the profits for themselves by increasing their salaries, rather than putting the profit towards repayment of the loan to MDLF. Actually happened in real life; editors started buying Armani suits and BMWs. Dumbasses.

--Way to prevent this is for MDLF to insist on clauses in the loan agreement that prevent editors from tinkering with their own compensation without the permission of MDLF.

--Do this by making sure that HN cannot make any changes in editors' compensation without approval of shareholders. MDLF, then, in loan agreement stipulates that shareholders of EC cannot make any changes without permission of MDLF.

- See Sec.II, vol II, 7 &8 to see this structure.
- Note: although Anderson failed to do this in real life, lawyer should make sure lender retains residual stock interest, so if venture profitable, MDLF can capture part of profit. Thus, in contract make sure to take a **convertible interest** where able to convert debt to stock. In other words, bonds could be converted into stock of News Company.
- In conclusion, what we want to do to solve credit risk problem in third option is to make sure value flows back to Editors Company where stock interest is held, to ensure that MDLF will be paid back.

(3) RZB Revolving Credit Loan Agreement

- The RZB agreement is a "revolving credit" loan agreement. It is basically a credit card agreement, with the amount of available credit constantly revolving and changing, depending on how much you've spent and how much you've paid off.
- LIBOR (London Inter Bank Offering Rate)--variable rate that fluctuates as the market shifts.
- 10 million facility. Interest is LIBOR plus 0.25 p.a.. Interest rate captures/reflects/includes

- (1) a risk premium,
- (2) a fee for cash management service,
- (3) the rental value of money, and
- (4) the inflation rate (if applicable).

- How are payments applied to the outstanding balance? First excess charges (late fees, penalties, etc.), second interest, and third principle is paid.
- How much risk (and of what kind) has the bank actually assumed?
 - Not a lot, because the agreement requires that the borrower obtain a guarantee from a third party bank. Another bank or coalition of banks, is guaranteeing that the borrower will pay.
 - RZB, therefor, sees the transaction as the provision of a service. Their risk premium is very, very small. The interest fee mostly represents the cost of providing a cash management service.
 - In the second transaction between the third party bank and the borrower, a fee is paid which represents the risk premium
- In separate agreements not attached here, there is another risk aversion tool for RZB. It is referred to in section 8 (Set-Off), which allows the bank to apply a credit balance that the borrower might have in a separate RZB account toward any default debit balance.
- Also, there is a provision (here or in a separate document?) RZB requires that the amount paid must include any taxes that might be incurred in the transaction.

Explaining Two Borrowing Tracks Under Revolving Credit Facilities

- There are two different situations to be addressed:
 - (1) There is an immediate need for cash. In such a case you need to be able to get money quick, but you are going to pay high premiums/interest rates for that accessibility; and
 - (2) There is less immediate need for cash. In such case you give the bank so many days notice, and they can offer you a lower interest rate.
- Bank can offer a lower interest rate on the latter because they know in advance that you will need money, how much you will need, and when you will pay it back; because they have this information, they can go out and get take out a loan somewhere else at an even lower interest rate. The spread captured by the bank is reflected partially in their bottom line, but also is reflected in lower borrowing costs/interest rates to borrower.
- In the former case, the bank will be less able to get a good rate on a CD or whatever, so they have no savings in borrowing costs/interest rates to pass on to the borrower.

RZB Model Loan Agreement

- Also a revolving credit agreement, despite name.
- Sec. 2.3. Notice of Intention and Commitment to Borrow
 - First type of withdrawal (LIBOR plus a certain percentage) requires notice. If the bank has enough notice, they have the time to purchase a certificate of deposit to mirror the borrowing, which in the end results in lower borrowing costs for the entire transaction. Time stream for repayment is fixed at whenever the certificate of deposit is due. Because the longer the period of maturity on the CD, the more risk attributed to the bank, the bank will usually require that the repayment period be relatively short.
 - The second kind (Fed Funds rate plus certain percentage--“swing-line borrowing”) requires no notice. Time stream for repayment is flexible.
 - So basically, if you choose the former type of borrowing, you will pay less interest, but you will also have to wait a few days before receiving the money and you will have a set time to repay the loan.

--Using LIBOR for one track and Fed Funds rate for the other track is just what was contracted here. There is no requirement or tendency for one rate or the other to be used for one track or the other.

- Is there a problem with allowing the State to be the sole guarantor on a loan taken out by a state-owned company. Yes there is, because the State has sovereign immunity from being sued. What if the borrower defaults, and the State refuses to pay?
- So what would you do to avoid this problem? Require the State to waive sovereign immunity as guarantor. Force State to keep liquid assets in a country other than the State's (particularly in the bank's country). Could also require that the State receive a further guarantee from a non-State bank.

Escrow

- Security deposit held by a third party. In this context, a borrower would give money to a third party in as part of a loan agreement; if the borrower were to default on the loan, a court could direct the third party to pay the money in the escrow account to the lender. If, on the other hand, the loan agreement runs its course without default, the money is eventually returned to the borrower by the third party.

V. PAYMENTS--LETTERS OF CREDIT

Reading

- Letter of Credit Stuff

Letters of Credit, etc.

- We've done Financial Markets, Money & Credit Transactions, and now we will move on to Mechanics of Money Movement and the topic of Documentary Credit/Letters of Credit.
- In an increasingly global market, there are very often buyers and sellers who do not know each other, and therefore do not trust each other. If Hector, a Chilean wine grower, is going to sell wine to Le Ken, a DC restaurant, they don't necessarily trust each other that the buyer will pay and that the seller will deliver the product exactly as promised.
- Banking system plays a major role in removing the levels of distrust. International trade still depends on trust, its just not trust between the buyer and seller. Documentary credit system shifts the issues of trust to the banks; can you trust your bank, and can the bank trust the other banks it works with. Basically, the banks create trust among each other, and they rent out the trust to the buyers and sellers. Banks charge a fee to rent trust, which is an extraordinarily important commodity in international trade.
- There are a million things that could go wrong in the Hector/Le Ken deal, everything from export/import regulations getting in the way, to theft, to natural disaster in transit, to poor product quality (all of which are contingent risks (?) that can be managed in the contracting).
- Credit risks are another story. They can only be managed via methods such as letters of credit.
- Ways of getting paid in a deal:
 - (1) cash in advance--seller receives cash from the buyer prior to shipment (buyer bears risk)
 - (2) on open account--goods are shipped to the buyer and payment is made through an arrangement negotiated in advance with the seller (seller bears risk)
 - (3) letters of credit--neither party bears risk; banks bear risks.
- With letters of credit, the credit risks are taken care of, and most of the contingent risks are taken care of. The only risks that remain are that the merchandise may not be as it is represented in the documentation (risk to buyer) and the payment of Letter of Credit will not be paid if the seller's documents do not conform exaction to the terms and conditions of the letter of credit (risk to seller).
- The documentation accompanying the letter of credit will include a list or requirements that must be met before the bank will release the money to the seller. The requirement must be completely objective; usually they are requirements that the bank receive documents evidencing things like the fact that the goods were delivered, that the goods were in good condition, etc.

- A letter of credit is an instrument issued by a bank in favor of a Beneficiary, which substitutes the bank's credit worthiness for that of the Applicant. In a broad sense, it is simply a letter of instruction issued to a Beneficiary (seller) by a Bank at the request of its customer (buyer). In a narrower sense, it is a specialized, technical instrument used to pay for a shipment of goods or services from one party to another.

- Letters of credit, in a way, represent the monetization of trust. The banking system basically "rents" trust to buyers and sellers in any transaction, but particularly in international business transactions, where distance and unfamiliarity breed mistrust.
- Role of the Bank in Letter of Credit Transactions

(1) Bank accepts payment (the money) from the buyer in trust (not literal, legal trust) for the benefit of the seller of goods.

(2) Bank promises not to release the money until “documentary” requirements are met by the seller.

• Question is what is the meaning of the term “documentary”? Documentary means

(1) The parties (buyer and seller) must specify a set of documents to be presented to the bank.

(2) Bank will not rely on any facts underlying the documents, but will rely on the authenticity of the documents alone (will look at the documents only their face; their facial validity).

--This system lowers the bank’s transaction costs; they don’t have to act as independent authorities on each and every good that is being bought and sold.

--Examples of type of documents that would be required in the Chilean wine transaction include (1) certificate that wine arrived in good quality, provided by a designated independent expert; (2) proof that there was no tampering with boxes, provided by shipping inspector at docks; (3) evidence of good title; (4) proof that all licenses, export/import stuff is in order.

• Big point of using letters of credit is to limit risk, reduce questions of trust, and reduce transactions costs.

Mechanics of Letters of Credit

• Straight L/C: none of the following variations apply. Usually in the form of a straight irrevocable L/C. “Irrevocable” means that the bank that has issued the letter of credit in favor of the buyer will wind up committing that once that letter is open (credit or money has been given) it will not withdraw it.

• L/C contract between bank and buyer, with the seller as beneficiary.

• Issuing bank--opens or issues an L/C. Person that opens the letter of credit is the applicant/buyer. Buyer asks issuer to open a letter of credit to the beneficiary/seller.

• One way an applicant can open a letter of credit is by giving the bank the money needed to open the letter of credit. More often, though, the applicant is known to the bank; the bank simply issues the letter of credit, paying the beneficiary and extending credit to the applicant.

• Paying bank: Issuer’s bank is usually in the buyer’s country, and has a relationship with a paying bank in the seller’s country. The two work together to complete a letter of credit transaction. There is no direct contractual relationship between the beneficiary and the paying bank; only issuing bank can be sued contractually.

• Confirming bank: The guarantor. Usually guarantees the issuing bank (?) that the payment will be backed up. Confirms the obligation of the issuing bank that the beneficiary will be paid. Confirming bank assumes the credit risk.

• System gets complicated, adding various parties, in an effort to make payments while at the same time allocating risks.

• Question to ask with credit transactions/letters of credit transactions: who is assuming the risk of the loss? Anywhere that credit is being extended, must ask who is assuming the risk.

• Two variations on the basic letter of credit:

(1) standby letter of credit--opened for the benefit of a seller, but nothing happens immediately. Only to be paid out if there is documentary evidence of default or some other contractually designated event.

(2) back-to-back letter of credit.

--Both are used to use a letter of credit as a guarantee.

When is Escrow Account Better than Documentary Credit

- There would be very few instances because documentary credit would almost always be easier, and would be much easier to organize.