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Risk Management and Funding

Risk Mitigation Instruments: Standard and Non-Standard Collateral

NAPCO Conference

January 22, 2015

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What We Will Discuss

- Security Agreement and Perfection
- Set-Off and Recoupment
- Guarantees
- Surety Bonds
- Letters of Credit
- Bank Payment Obligations
- Credit Insurance
- PUTs Contracts
- Political Risk Insurance
- CDS

Security Interest

- Article 9 of the UCC provides a uniform approach to the collateralization of obligations.

- A security interest is broadly defined as any interest in personal property or fixtures which secures the payment or performance of an obligation.

Creation of Security Interest

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- In order to create a security interest enforceable against the debtor, there are three requirements set forth in UCC 9-203(b):
  - The secured party must give value,
  - The debtor must have rights in the collateral, and
  - The debtor must have authenticated (*e.g.*, signed) a security agreement.
- An enforceable security interest can also be created by pledge (*i.e.*, by possession of the collateral) or in certain circumstances control of the assets.

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Perfection

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- Perfection functions as a formal scheme for the prioritization of rights of parties beyond the debtor or secured party.
- Prioritization accounts for competing claims to the same collateral.
- Four basic methods of perfecting security interests under the UCC
  - filing financing statements,
  - by possession,
  - by control, or
  - other methods under state and federal law, which involves the filing of certificates of title or other legal compliance (*e.g.*, automobiles)

Perfection

- Under Article 9, main focus of perfection is by filing with the Secretary of State in the location of the debtor

- In most scenarios, priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.

Financing Statement

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- For most business assets, the filing of a financing statement (UCC-1 form) in the appropriate location and containing the required information is the method of perfection.
- Although financing is required to list collateral, it can recite that it covers "all assets."
  - Article 9 embraces such a description of the collateral to accommodate the practice of creating a security interest in all, or substantially all, of a debtor's assets
  - Security agreement cannot use such a super generic description, but can describe collateral by category.

Set-Off and Recoupment

- Set-Off
  - Governed by state law
  - Mutuality requirement
  - Obligations need not arise from the same transaction
  - Governed by automatic stay provisions of the Bankruptcy Code
- Recoupment
  - Equitable right governed by state common law
  - Obligations must arise from same transaction
  - Not governed by the automatic stay provisions of the Bankruptcy Code

Guarantees

Guarantees Overview

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- Guarantees represent a promise by a third party to “stand in” for your counterparty in the event that your counterparty were to default on its obligations.

- Must be in writing - usually in a separate agreement

- Guarantees substitutes the creditworthiness of the guarantor for the lack of creditworthiness of your counterparty.

- Guarantees are normally provided when:
  - The financials of your counterparty (subsidiary) are not available.
  - The creditworthiness of your counterparty (a subsidiary) is in question.
  - Credit exposure has exceeded the creditworthiness of the subsidiary.

Guarantees – Key Benefits

- If you are a secured creditor
  - UCC lien holder
  - Designated creditor class

- They can very effective in bridging the gap between doable vs. non-doable deals

Surety Bonds

Types of Surety Bonds

- **Bid Bond:** Ensures the bidder on a contract will enter into the contract and furnish the required payment and performance bonds if awarded the contract.
- **Payment Bond:** Ensures suppliers and subcontractors are paid for work performed under the contract.
- **Performance Bond:** Ensures the contract will be completed in accordance with the terms and conditions of the contract.
- **Ancillary Bond:** Ensures requirements integral to the contract, but not directly performance related, are performed

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Surety Generally

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- Agreement to be primarily liable for the debt or another, regardless of the failure of another party to perform
- Primary liability and unconditional
- Usually executed simultaneously and in the same agreement

Surety Bond Defined

- A three-party agreement that legally binds together a principal who needs the bond, an obligee who requires the bond and a surety company that sells the bond.
- A surety bond is a written instrument. It does not stand alone, but guarantees the underlying contract or obligation. A company buys a bond because of an agreement with another company which requires a guarantee that a contract or obligation will be fulfilled.

Surety Bonds - Benefits

- Surety bonds are designed to protect the obligee from exposure to loss. Suretyship achieves this objective by prequalifying prospective principals on the basis of their credit strength, ability to perform, and character.
- Surety bonds provide financial guarantees that contracts and other business deals will be completed according to mutual terms.
- When a principal breaks a bond’s terms, the harmed party can make a claim on the bond to recover losses.

Surety Bonds - Benefits

- While the use of bank instruments or cash will generally fulfill your security requirements, a bond may offer unique benefits. Surety credit is separate from the principal's source of funding.
- This may enhance financial credit by decreasing the need for financing and associated interest expense.
- A bond may avoid an extended commitment of capital and allow greater efficiency of operation in the principal's business.

Performance Bond – Drawbacks

- Requiring insurance bond can increase costs – cost of obtaining bond is often passed on in the cost of performing under the contract

- Requiring performance bonds may exclude smaller firms from bidding, as certain firms may either be unable to obtain performance bond or may need to pay significantly greater cost to underwriter

Letters of Credit (LC's)

LC's – Overview

- A Letter of Credit (LC) is a promise by a bank to make a demand payment to the holder of the LC under specified conditions.
- Letters of Credit come in several forms:

Documentary letters of credit	Standby letters of credit
• Export / Import	• Financial / Performance

Letter of Credit

- An “absolute” guaranty
- Written undertaking, usually by a financial institution
- To pay the creditor
- Upon satisfaction of conditions stated in letter of credit

Effect of Letter of Credit

- Creates primary obligation on part of issuer
- Independent of underlying debtor owed by obligor
- Issuer must pay, even if creditor has breached underlying contract

LC's – Key Benefits

- Highly secure
- Often less expensive to the seller than other forms of mitigation ***(straight cost – not opportunity cost)***
- Generally known and understood by many

LC's – Pitfalls/Misconceptions

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- Document heavy
- Often requires labor-intensive document review
- Usually requires counterparty to post-collateral
- Less customer friendly

Letters of Credit -
Common Discrepancies

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- L/C has expired prior to presentation of draft.
- Invoice amount not equal to draft amount.
- Names of documents is not EXACT as described in the credit. (Beneficiary info must be exact)
- Invoice/settlement/acceptance not signed as stipulated in the L/C.
- Description of product is not covered by the L/C.
- A required document of the L/C is not presented.
- Documents do not match L/C exactly – (volumes, price, description etc…) – get on TradeXchange – Trade Platform.
- Documents are presented late (past time allowed in L/C).
- Transportation of goods outside L/C terms.

Defenses to Letter of Credit

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- The demand does not comply with the terms and conditions of the letter of credit
- A document required to be presented with the letter of credit is forged or fraudulent
- Honoring the draw would facilitate a material fraud by the creditor

Effect of Obligor's Bankruptcy on Letter of Credit

- Letter of credit is not property of the estate
- Money paid under letter of credit is not property of the estate
- Automatic stay issues
- Preference issues
- What happens when you hold a letter of credit but receive payment from obligor during 90 days pre-bankruptcy?

Credit Insurance

Credit Insurance – Overview

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Trade credit insurance protects a company's commercial accounts receivable from unexpected and catastrophic losses resulting from insolvency or "non/slow-payment“.

Credit Insurance– Key Benefits

- Risk Transfer
- Protects against catastrophic events/ risk mitigation
- Increases sales both domestically and internationally
- Enhances and supports the credit management function
- Improves/facilitates internal and external financing
- Reduces amount of product needed to sell to make up for bad debt loss
- Alternative to L/C

The Basic Coverage

Commercial Risk – Domestic/Export

- Buyer Insolvency
- Protracted Default
- Non Acceptance
- Contract Frustration

Political Risk – Export

- Inability to obtain hard currency
- Changes in Import/Export regulations
- Contract frustration due to Act of War
- Foreign government non-payment

Types of Insurance Coverage

- **Cancelable Limits** – Carrier assists in monitoring accounts and provides warning and guidance in the event there is increased likelihood of default

- **Non-Cancelable Limits** – Carrier will not cancel limits, but the action of the limit could cancel itself.

Credit Insurance – Misconceptions / Pitfalls

Misconceptions

- Inflexible
- Expensive
- Only Covers Good Buyers
- All Limits are Cancelable

Pitfalls

- Buyer Coverage
- Conditionality of Policy/Performance Risk

Credit Insurance – How it is Priced

- Priced on Sales

- Priced on Coverage

<u>Pricing and Variables</u>

- Buyer Quality / Industry

- Applicant

- Terms of Sale

PUTs

PUTs - Overview

- Long-form Credit Default Swap contract tailored to reference trade receivables
- Option is triggered upon the bankruptcy or insolvency of the Obligor on the receivables (the "Buyer")

Puts – Key Benefits

- Non-cancelable/non-modifiable
- Varying tenors (e.g. 6 months, 9 months)
- Any industry. Most public companies; on many private entities.
- *Effective immediately* on ALL outstanding accounts receivable to the customer (not just new receivables incurred after protection is purchased).
- Possibly available even where a financial/securities hedge is NOT available.
- Available **during a Buyer's bankruptcy**.
- Assumes a first-loss position; generally, there is **no deductible**.

Puts – Pitfalls/Misconceptions

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- Single accounts only; no discount for a portfolio
- Minimum amounts (*e.g.* $1mm)
- Only triggered upon a bankruptcy filing; <u>not</u> a failure to pay
- Need to identify the proper debtor
- Normally, payout upon validation of the claim

Puts – How They are Priced

- Considerations:

- Public vs. Private
- Does the market have an opinion on the yield for the unsecured debt of the company?
- If not (only secured debt and/or equity), what is a comparable company?

- Hedge available or not? Illiquidity discount (versus similar securities)

- Length of protection

Bank Payment Obligations

<u>“BPOs”</u>

Bank Payment Obligations (BPO) - Overview

- Bank Payment Obligation (BPO) – Alternative instrument for trade settlement

- The ICC Banking Commission and financial messaging service provider SWIFT have developed and adopted an industry-wide standard for the BPO.

BPO – Alternative Payment Instrument

- BPO is an irrevocable undertaking of one bank (typically, buyer's bank) to pay another bank (seller's bank) on a specified date after successful electronic matching of trade-related data.

- Essentially, BPO is an alternate payment instrument to settle international trade with automated processing and reduced risk.

BPO - Slow to Gain Traction in Market

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- Marketed as occupying sweet spot between the L/C and open account/supply chain finance arrangements
  - Provides risk mitigation and access to liquidity typically associated with a L/C, while bringing many of the operational efficiencies of open account.
- Banks that are interested in offering BPO services need to invest in the infrastructure required to handle the electronic transactions.
- Adoption rate by banks and volume of BPO transactions remains low

Political Risk Insurance

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Political Risk Insurance - Overview

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- War and Political Violence (PV)
- Economic instability
- Confiscation, Expropriation and Nationalization (CEN)
- Non-Honoring (sovereign guarantees, letters of credit)
- Deprivation of Capital
- Embargo
- License Cancellations

Political Risk Insurance - Overview Cont…

- Non Transfer
- Currency Fluctuation
- Divestiture
- Contract Frustration
- Business Interruption
- …. ***And Many Others***

Political Risk Insurance – Key Benefits

- Protects
  - Physical Asset Protection
  - Investment Protection
  - Contract Value Protection

Political Risk Insurance – Pitfalls/Misconceptions

- Misconception –
  - Not many companies underwrite it
- Pitfalls –
  - Performance Risk
  - Waiting Periods
  - Can be complicated

Political Risk Insurance – How is it Priced

Per Annum Rate normally based on the value of the contract or project

CDS

CDS - Overview

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- CDS (Credit Default Swap) is a derivative that protects the principal value of a debt instrument
  - BUYER of CDS/Protection, SHORT credit (benefits from a drop/downgrade); Pays quarterly fixed-rate premium
  - SELLER of CDS, LONG Credit (benefits from a rise/upgrade); Receives premium, guarantees par value of debt
- Generally 5-Year Term; Other Liquid points are 1-yr, 3-yr, 7-yr, 10-yr; minimum is 1-yr
- "Rolls" every 3 months (Mar, Jun, Sep, Dec 20th)
- Fixed Rate, Quarterly Payments Paid Until Maturity or Credit Event
- Credit Event generally means a default/failure to pay or bankruptcy with respect to bonds

CDS – Key Benefits

- Use of credit-default swap (“CDS”) to hedge credit-risk embedded in bonds and isolate interest-rate risk
- Use of CDS (“*naked*”) to bet on the credit direction of a company

CDS – Pitfalls/Misconceptions

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- Coverage on bonds and loans; NOT supplier's accounts receivable
- ISDA (Int'l Swaps and Derivatives Assoc.) agreement required; can take up to a month+ to negotiate
- Only available on **certain publicly-traded companies**; holding companies and ***not*** operating subsidiaries
- Available in $1MM increments
- Only available before bankruptcy
- Need to mark-to-market
- Settlement via a Dutch-auction

CDS – How it is Priced

- "Credit Spread"- the spread between Treasuries and non-Treasury securities that are identical in all respects for quality rating
- "Points Up Front" with "running" (100bps or 500bps)