

CROSS-BORDER LENDING

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This article discusses cross-border lending issues related to taxes, security, and available remedies, as well as the security and insolvency laws of Canada and Mexico.

Globalization of business has accelerated. In order to remain competitive, lenders must be prepared to structure transactions with cross-border lending features — loans to foreign borrowers or loans against the value of foreign borrowers' assets. Cross-border lending requires lenders to address issues related to taxes, security and available remedies. This article briefly discusses these issues and focuses on the laws of Canada and Mexico relative to security and insolvency.

TAX ISSUES

Two tax issues that are prevalent in every cross-border loan transaction are: (1) the U.S. "deemed dividend" rule; and (2) the foreign jurisdiction's withholding tax rules. Usually the deemed dividend issue comes to the forefront when a borrower informs a lender that it can only take a pledge of less than 2/3 of a controlled foreign subsidiary's stock.

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IRC § 956-THE “DEEMED DIVIDEND RULE”

Under Internal Revenue Code (“IRC”) § 956, the obligation of a U.S. corporate parent to a lender will trigger (with limited exception) a “deemed dividend” of the controlled foreign subsidiary’s current and accumulated earnings and profits up to the amount of the U.S. loan obligation if any one of the following three events occurs: (1) 66 2/3 percent or more of the controlled foreign subsidiary’s combined voting power of all the classes of stock entitled to vote is pledged to the U.S. parent’s lender (accompanied by certain restrictions on the disposition of the controlled foreign subsidiary’s assets and the incurrence by the subsidiary of liabilities other than in the ordinary course of business); (2) the controlled foreign subsidiary is a guarantor (directly or indirectly) with respect to the loan made to the U.S. parent; or (3) the controlled foreign subsidiary grants a security interest in its assets to secure the loan to the U.S. parent.

If a deemed dividend is triggered, the U.S. parent’s pro rata share of the controlled foreign subsidiary’s current and accumulated earnings and profits may be subject to U.S. income tax up to the amount of the U.S. loan obligation. Generally, if the controlled foreign subsidiary’s current and accumulated earnings and profits are less than the amount of the U.S. obligation, then the controlled foreign subsidiary’s future earnings and profits may be subject to the deemed distribution up to the amount of the U.S. loan obligation (after accounting for prior deemed distributions).

Borrowers and lenders often assume that a U.S. parent cannot pledge the stock of a controlled foreign subsidiary and that a controlled foreign subsidiary cannot guarantee or pledge its assets in support of the loan to the U.S. parent because of the tax consequences outlined above. However, the amount of the deemed dividend and its actual economic impact on the borrower will depend on the borrower’s particular facts and circumstances and the borrower’s overall tax position and can be quite complex. There are many situations in which the application of IRC § 956 has no material adverse impact on the borrower including:

- the controlled foreign subsidiary has no accumulated earnings and profits and is not expected to have any in the future, or the controlled foreign subsidiary already distributes its income to the U.S.;

- the consolidated U.S. tax group has operating losses that reduce or eliminate the deemed dividend;
- the IRC already requires inclusion of the controlled foreign subsidiary's earnings and profits in the U.S. parent's income prior to actual distribution of the earnings and profits for other reasons; and
- U.S. tax credits may be available to largely offset the U.S. tax liability from the deemed dividend because the controlled foreign subsidiary may have paid taxes to a foreign jurisdiction with respect to the earnings and profits giving rise to the deemed dividend.

Thus, the application of IRC § 956 may not have a material adverse impact on the borrower, depending on the circumstances. The lender should require the borrower to provide an analysis of the impact of IRC § 956 before deciding that it cannot obtain a pledge of the equity interests in, or a guaranty or asset pledge from, a controlled foreign subsidiary. In situations where IRC § 956 does have a material adverse impact, other structuring alternatives will need to be considered. For example, the lender's affiliate organized in a foreign jurisdiction may be able to loan directly to a subsidiary organized in that jurisdiction and close any collateral deficiencies by obtaining collateral support from subsidiaries located in other foreign jurisdictions.

WITHHOLDING TAX ISSUES

Many foreign jurisdictions impose a withholding tax on certain income (e.g., interest, management and administration fees and dividends) paid by a resident of the foreign jurisdiction to a resident of another jurisdiction. Thus, a U.S. lender that contemplates making a loan to a foreign borrower must consider whether the laws of the foreign jurisdiction will require that a portion of its interest payment be withheld and paid to a foreign taxing authority. The amount of withholding tax imposed may be reduced or eliminated by treaty between the jurisdictions or by other legislation. An amendment to the Canada-U.S. treaty was entered into force on December 15, 2008 which has eliminated withholding tax on most non-related party interest between U.S. and Canadian residents effective retroactively to January 1, 2008. Canada had previously enacted independent domestic legislation that eliminated

withholding tax on most non-related party payments of interest on or after January 1, 2008. Thus, with certain exceptions, after January 1, 2008, U.S. lenders are able to make cross-border loans to Canadian borrowers without the imposition of a withholding tax on interest payments. The treaty between the U.S. and Mexico limits the withholding tax on interest paid by a resident of Mexico to a resident bank of the U.S. to 4.9 percent.

Most lenders consider any withholding tax liability to be the responsibility of the borrower. As a result, most loan agreements contain a “gross-up” clause, which requires the borrower to compensate the lender for any withholding tax imposed by a foreign jurisdiction. As a result of withholding taxes, a local lending source in the jurisdiction of the foreign subsidiary may be necessary.

Other tax issues, in addition to the deemed dividend and withholding tax rules described above, may apply to a transaction and may have an effect upon the loan structure. The lender will need to consider all potential tax issues in the U.S. and in the relevant foreign jurisdictions.

COLLATERAL SECURITY

Many countries do not have a uniform procedure for taking a security interest in tangible and intangible assets sought by secured lenders, such as the Uniform Commercial Code (the “UCC”) in the U.S. and the Personal Property Security Act (the “PPSA”) in Canada (or pursuant to the Civil Code of Quebec (the “CCQ”) in the Province of Quebec). Instead, security in many countries is dictated by multiple statutory schemes and common law, which are sometimes overlapping and contradictory. The lack of a unified scheme for taking security often deters U.S. lenders from making loans to foreign borrowers or against foreign assets located in those jurisdictions.

In the U.S., lenders are accustomed to being able to take a blanket or floating lien over the current and future assets of its borrower to secure current or future debt. This is not the case in some foreign jurisdictions. In some countries, the lender may be able to take a pledge only over specifically described existing assets and may not take a lien on any after-acquired property. In other countries, the lender may be able to take a lien over after-acquired property, but not with ease (e.g., the account debtors must be specifically identified and notified

of the lien). The U.S. lender's inability to take a blanket lien over current and future assets to secure current and future indebtedness impedes a U.S. lender's ability to make asset-based loans in those jurisdictions.

There is large variation from country to country in the scope of assets that may be covered by a lien, whether after-acquired property may be covered by a lien, the priority of creditors that may be repaid ahead of a lender's lien and the procedures relating to the realization on the lender's collateral. Generally, common law jurisdictions (e.g., the UK) are thought to be more floating lien friendly than civil law jurisdictions (e.g., France), but it is easy to overgeneralize. The lender must look to and be familiar with the law of the jurisdiction in which the collateral is situated. Hiring competent local counsel is essential.

UCC § 9-301(1) provides that the perfection of a nonpossessory security interest in collateral is governed by location of the debtor. The location of the debtor, within the meaning of the UCC, will differ depending on the type of debtor and the laws of the jurisdiction in which the debtor is located. UCC § 9-301(1) does not change depending upon the location of the collateral. However, it would be a mistake for a lender to rely on UCC § 9-301(1) as granting it the rights the lender needs against a foreign borrower or in collateral located in or arising from a foreign jurisdiction. The UCC often will not supply the law to determine the perfection and/or priority of the U.S. lender's lien with respect to a foreign borrower or for collateral located in or arising from a foreign jurisdiction.

COLLATERAL AVAILABILITY

The following is a brief description of collateral availability in Canada and Mexico. The primary collateral relied upon by asset based lenders, accounts receivable, inventory and bank accounts, is emphasized.

Canada

In Canada, nine out of 10 provinces and all three territories have adopted (with some variations) the PPSA. The PPSA resembles the UCC and, in particular, the PPSA recognizes the concept of a floating lien over debtor's current and future assets to secure current and future indebtedness. Quebec's personal

property security system is set forth in the CCQ. In Quebec, the hypothec allows a lender to obtain a charge on current and future movable or immovable property, and allows for registration of security under the Register of Personal and Movable Real Rights (“RPMRR”). Thus, in Canada, lenders may obtain a floating lien over accounts, inventory and other assets. With certain exceptions, a lien is perfected, in a PPSA jurisdiction, by filing a financing statement in the personal property security registry in the applicable province or territory and, in Quebec, by filing a registration with the RPMRR. Like the UCC, the PPSA allows a lender to pre-file, but the CCQ does not; under the CCQ, an executed security agreement or hypothec is needed to file.

Both the PPSA and CCQ permit a lender to obtain security in deposit accounts. Unlike the UCC, the PPSA and CCQ allow the lender to perfect its security interest in deposit accounts through registration rather than control. In addition, many Canadian banks in Canada’s provinces and territories will enter into lockbox and blocked account arrangements. Despite the similarities between the UCC, PPSA and CCQ in the collateral that may be obtained, there are important differences including, without limitation, with respect to the priority of the lender’s lien.

Mexico

Beginning in 2000 and continuing in 2003, Mexico enacted various amendments to its commercial laws, which created two new security devices for secured lenders: the nonpossessory pledge and guaranty trust. As a result, a secured creditor can take a blanket lien over all present and future movable personal property in Mexico including accounts, inventory and proceeds. If the nonpossessory pledge is used, the debtor retains title and possession of the secured assets. If the guaranty trust is used, the borrower remains in possession of the secured assets but transfers title to the secured assets to a trustee as collateral to secure payment of the obligations of the debtor to the lender.

Only Mexican banks and other prescribed Mexican financial institutions can act as trustees. The guaranty trust is generally used in larger transactions because it is more expensive (the trustee may charge an initial fee, annual fees and enforcement fee) than the nonpossessory pledge. The two main advantages of the guaranty trust over the nonpossessory pledge are that it:

(i) allows for nonjudicial enforcement; and (ii) separates the trust property from the debtor's estate and beyond the reach of its creditors (even in an insolvency proceeding). For the nonpossessory pledge and guaranty trust to be effective against third parties, a registration form similar to but requiring more information than a UCC financing statement must be registered in the Public Registry of Commerce at the place of the debtor's domicile, which is transmitted to a central filing office in Mexico City. Special registrations are required for certain types of collateral.

ENFORCEMENT; INSOLVENCY

The law of the foreign jurisdiction dictates the types of enforcement actions available to lender. In some jurisdictions, for example, the self-help remedies (e.g., direct collection from account debtors) to which U.S. lenders are accustomed are not available. A myriad of local laws of the foreign jurisdiction may affect the ability of the lender to realize on its collateral. Insolvency proceedings and practices vary from jurisdiction to jurisdiction and may be very different from U.S. bankruptcy proceedings.

The lender needs to understand the availability of remedies and insolvency procedures of the foreign jurisdiction in determining whether and how to lend in that jurisdiction. For example, a lender lending in Mexico would want to consider using a guaranty trust rather than a nonpossessory pledge so that the lender would have access to self-help remedies. A brief description of remedies available to secured lenders outside of insolvency proceedings and of insolvency proceedings in each of Canada and Mexico follows in the table set forth at the end of this article.

ENFORCEMENT RISK AREAS

Each foreign jurisdiction will have its particular enforcement risks that the secured lender will need to understand and address in its loan documentation and structuring including, without limitation, priming claims, title retention clauses (e.g., a conditional sale agreement or financing lease) and anti-assignment provisions. The lender will want to establish borrowing base reserves or consider obtaining insurance or consider alternative structures to

address priming claims. The lender needs to understand whether notice of a title retention clause is required to be filed in a public registry to be enforceable against a secured lender. If there is no such requirement and lender fails to discover the existence of a title retention clause, it can mean for example, that inventory on which lender has extended credit and which appears to be covered by the lender's lien is not actually part of the lender's collateral until title passes to the borrower upon payment of the invoice.

The lender also needs to know whether there is legislation in the foreign jurisdiction similar to the UCC that generally renders ineffective any term in an agreement between an account debtor and the borrower that prohibits or restricts the assignment of, or creation or enforcement of a security interest in, an account. The lack of such legislation can mean that a secured party seeking to force an account debtor to pay it might be faced with the defense that the borrower breached its contract by assigning to the lender the right to payment from the account debtor. In these jurisdictions the lender may need require its borrower to obtain consent of the account debtor to the security interest.

While a full description of enforcement, insolvency and enforcement risk in Canada and Mexico are beyond the scope of this article, the table set forth at the end of this article summarizes those subjects together with collateral security matters discussed above by comparing them with the corresponding U.S. legal provisions with which U.S. lenders are familiar.

DRAFTING ISSUES

The lender in a cross-border loan transaction must address a variety of other issues not encountered in domestic loan transactions. The lender's loan documents may need to be modified to address currency risk, foreign currency loans, logistical concerns (such as time differences) and a variety of other matters pertaining to the foreign jurisdiction. For example, the loan documents should require the borrower to compensate the lender for any loss that may result from changes in the exchange rate between the time a judgment is entered in a foreign jurisdiction and currency and the time payment is received in U.S. funds.

As another example, the U.S. lender may want to set dollar limitations on foreign currency loans, allow for the unavailability of an agreed-upon for-

eign currency and require the borrower to compensate lender for increased costs related to the offering of the foreign currency. The lender will need to consider the choice-of-law and choice-of-forum provisions more carefully in a cross-border loan transaction. For example, the lender will want to preserve its option to sue the debtor in the debtor's jurisdiction if the lender believes that forum would be necessary to or improve its enforcement rights.

CONCLUSION

The globalization of business has required many U.S. lenders to make loans to foreign borrowers or against foreign assets. While cross-border lending often provides great opportunities for lenders, those opportunities entail issues and risks not present in domestic loan transactions. Lenders will need to consider the application of U.S. laws not applicable to domestic loan transactions and the laws of the foreign jurisdiction. The laws of the foreign jurisdiction may operate very differently from U.S. law. Lenders should consult knowledgeable counsel to properly structure their loan transactions.

Comparison of Security and Insolvency Laws			
Characteristics	United States	Canada	Mexico
SECURITY			
Scope and Uniformity	UCC is single legal framework applicable to most consensual liens in personal property	All provinces (other than Quebec) and the three territories have adopted PPSA as single legal framework applicable to most consensual liens in personal property	Multiple mechanisms in different legal frameworks for taking consensual liens over personal property (e.g., pledges, trusts, consignments, title retention, etc.)

Comparison of Security and Insolvency Laws, cont.

Characteristics	United States	Canada	Mexico
Perfection by Filing	Allows perfection by filing for most types personal property	Allows perfection by filing for most types of personal property collateral	Allows perfection by filing with respect to most types of personal property collateral
Notice Registry	For most types of collateral, financing statement to be filed in the applicable Secretary of State Office	For most types of collateral, PPSA financing statement must be filed in the applicable PPSA province or territory, and statutory form to be filed in the applicable registry within Quebec	For most types of collateral, registration form to be registered in the Public Registry of Commerce in place of debtor's business, which is transmitted to a central filing office in Mexico City
After Acquired Property and Proceeds	Security interest may include after acquired property and proceeds	Both PPSA and CCQ provide for liens on after acquired property and proceeds	Both guaranty trust and nonpossessionary pledge may include after acquired property and proceeds
Future Advances	Allows collateral to serve as collateral for future advances	Both PPSA and CCQ allow collateral to serve as collateral for future advances	Allows collateral to serve as collateral for future advances

Comparison of Security and Insolvency Laws, cont.

Characteristics	United States	Canada	Mexico
Self-Help Remedies	Self help remedies are available without a breach of the peace	Self help remedies are available. Receivers are often utilized by lenders outside of court proceedings to take possession of and sell collateral. However, in Quebec, if a debtor does not voluntarily surrender the collateral to lender, court intervention will be required	Self help remedies are available with respect to a guaranty trust. With respect to a nonpossessory pledge, however, the debtor must be notified of the proposed repossession and the procedure appears to, essentially, require debtor's consent. Further, significant delays in court have been encountered in the past and it is not yet clear whether the new expedited procedures will significantly alter this experience
ENFORCEMENT; INSOLVENCY The insolvency comments in this chart relate to		This summary relates to the Companies' Creditors Arrangement Act ("CCAA") and not the Bankrupt-	

Comparison of Security and Insolvency Laws, cont.

Characteristics	United States	Canada	Mexico
business reorganizations		cy and Insolvency Act ("BIA") unless otherwise indicated below	
Commencement	Debtor or at least three creditors holding unsecured, noncontingent, undisputed claims totaling at least \$13,475	Typically the debtor, but a creditor could commence	Debtor, a creditor or the public prosecutor
Solvency Requirements	Debtor need not be insolvent. If debtor contests an involuntary proceeding, the creditors must prove debtor is generally not paying undisputed debts as they come due	Debtor must be insolvent with aggregate liabilities of at least \$5 million. There is no specific test for insolvency, but the courts have utilized the cash flow and asset valuation tests of the BIA	Debtor has failed to pay at least two creditors, at least 35 percent of the debtor's obligations are at least 30 days past due and the debtor lacks assets to pay at least 80 percent of its debts. An examiner is appointed to confirm the foregoing requirements are satisfied
Control Rights	Debtor generally in control. A trustee or exam-	Debtor generally continues in control. A moni-	Debtor generally continues in control. Concili-

Comparison of Security and Insolvency Laws, cont.

Characteristics	United States	Canada	Mexico
	<p>iner may be appointed in certain circumstances</p>	<p>tor is appointed but generally does not play an active role in debtor's management</p>	<p>ator is appointed to, among other things, mediate between debtor and creditors to achieve agreement on a plan of reorganization and oversee the operations of debtor</p>
<p>Automatic Stay Against Creditor Actions</p>	<p>Most creditor actions are automatically stayed</p>	<p>Stays are not automatic, but the court will usually grant broad stay against creditor action in the initial order, which the court may continue indefinitely</p>	<p>Creditor execution and foreclosure actions are generally stayed with exceptions for certain labor claims and certain secured creditor actions</p>
<p>Plan Acceptance; Cram Down</p>	<p>A reorganization plan is subject to creditor vote and court approval. A class accepts the plan with a vote of at least two thirds in value and one-half in number. A plan</p>	<p>Secured and unsecured creditors in separate classes. Each class must accept by majority in number and two-thirds in value. There is no cram down</p>	<p>Plan must be approved by 50 percent in the aggregate value of unsecured and secured claims. Secured creditors who do not agree to the plan may begin foreclosure</p>

Comparison of Security and Insolvency Laws, cont.

Characteristics	United States	Canada	Mexico
	<p>can be confirmed over a dissenting class (i.e., a cram down) if the plan is accepted by one impaired class, the nonaccepting classes receive as much as they would in a Chapter 7 liquidation and the plan is fair and equitable to such creditors</p>		<p>proceedings unless plan provides for payment of the value of their claims. There is, as a practical matter, no cram down</p>
<p>New Financing in Reorganization</p>	<p>New financing may be given priority over existing secured claims under certain circumstances</p>	<p>Does not currently have specific provisions dealing with new financing having priority over existing secured claims. New financing with such priority is currently not typical but may occur under the CCAA. Canada is considering amendments to the CCAA that would explicitly allow the courts</p>	<p>Mexico's insolvency law does not have detailed provisions, and it is not yet clear whether a debtor may obtain new financing with priority over existing financing</p>

Comparison of Security and Insolvency Laws, cont.			
Characteristics	United States	Canada	Mexico
		to grant priming liens in favor of new DIP lenders	
Outside Time Limit of Plan	There is no outside time limit for the reorganization proceeding to be concluded. However, the debtor loses the exclusive right to file a plan after 120 days after the order for relief as been entered	Under CCAA, there is no outside time limit in which plan must be accepted	Conciliation agreement must be reached within 185 days, but may be extended for two 90 day periods with court approval
Priming Claims	Only claims relating to the preservation of specific collateral can have priority over existing secured claims	Currently, certain governmental obligations, including, employee income taxes, employment insurance contributions, pension obligations and sales taxes. Canada is considering amendments to the CCAA that would allow the courts to grant priming liens or	Claims for salary and severance for up to two years and expenses of realizing collateral may be paid out of assets securing a nonpossessory pledge

Comparison of Security and Insolvency Laws, cont.

Characteristics	United States	Canada	Mexico
		<p>claims for: (i) employee wages up to \$2,000 per employee; (ii) certain charges for unpaid normal pension contributions; (iii) administrative charges for the monitor, the financial, legal and other experts of the monitor, the debtor and other “interested persons;” (iv) charges to secure indemnity obligations of the debtor to directors and officers; (v) charges in favor of persons providing DIP financing; and (vi) charges in favor of “critical suppliers”</p>	
Avoidable Transaction	Preferences and fraudulent transfers may be avoided under the Bankruptcy	Intercompany guaranties have generally not been successfully challenged under	Transaction entered into 270 days before an insolvency judgment (or

Comparison of Security and Insolvency Laws, cont.

Characteristics	United States	Canada	Mexico
	Code. Fraudulent transfer includes both constructive fraudulent transfers (those made without reasonable equivalent value while the debtor is insolvent or which render the debtor insolvent or with unreasonably small capital) and those made with actual intent, to hinder, delay and defraud	federal bankruptcy statutes or provincial fraudulent transfer provisions	longer to the actual date of actual insolvency if ordered by the bankruptcy court upon the request of a creditor or the conciliator) may be set aside if it is considered to prejudice creditors' interest, including transactions in which the debtor received no consideration or consideration significantly below fair market value

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