

Going Global—The Key to Success in the New Millennium: An Overview of Legal Issues

By William S. Veatch

Increasingly, to stay competitive, lessors need to provide financing on a global basis. However, that will become easier because of the increased level of uniformity of documentation that vendors are demanding. Here is a review of the primary legal issues in a domestic vendor program, followed by a look at other issues that emerge when the vendor program goes global.



The ability to provide lease financing globally is quickly becoming a necessity in the vendor program business. The demand for global lease financing will continue to grow as more and more vendors begin to market, sell and license their products over the Internet, taking advantage of the latest e-commerce tools. That is not to say that every leasing company that enters into vendor programs will need to open up offices worldwide. It does mean, however, that most leasing companies would be well advised to become familiar with the basic issues involved in doing business internationally and should know how to respond when the vendor asks: “Can you provide a lease to our customers in Australia, Japan, Singapore, France, Germany, and the United Kingdom?”

From a marketing standpoint, knowing how to respond to the vendor’s request for help in expanding internationally is critical. There are two noticeable trends in recent years. First, a number of lessors with headquarters in the United States have expanded their leasing operations overseas. Second, a number of foreign lessors have expanded their leasing operations into the United States. As a result, there are already a number of financing options available to the vendor who is selling, leasing, or licensing its products globally. Ease of administration and documentation will dictate that the vendor chooses a lessor who can accommodate the vendor’s business in each country where it has a presence. Clearly, competitive pressures will force lessors to address globalization, perhaps reluctantly in some cases, but enthusiastically in others.

This article will give the lessor some guidance as to how to prepare for the inevitable.

PRIMARY LEGAL ISSUES IN A DOMESTIC VENDOR PROGRAM

Before looking at the unique issues arising in the context of a global vendor program, it is helpful to review some of the key legal issues in a domestic vendor program. All these issues are, after all, still critical from a business standpoint in whatever country the customer is located. The legal issues can be divided into three broad categories of financing: equipment leasing, software financing, and financing service and maintenance fees.

Equipment Leases

Of the three categories of financing, equipment leasing is clearly the best understood. In whatever country the customer is located, it is relatively easy to determine the appropriate form of lease documentation to use with the lessee/customer. Some of the issues that are typically covered in the vendor program agreement between the vendor and the lessor include the following:

- Has the customer duly authorized and executed the underlying lease? If not, who bears that risk?
- Is the underlying lease documentation an enforceable obligation of the customer, payable come hell or high water? Again, who bears that risk, the vendor or the lessor?
- Has the customer accepted the equipment?
- If the underlying lease is deemed by a court to be a secured financing, is the transaction properly perfected?
- Has the customer waived defenses against assignees of the lessor?

Software Financing

Although generally speaking software financing is not as widely understood as equipment leasing, the principles are fairly well developed in the United States.¹ In addition to the issues listed

above with respect to equipment leases, the following issues should be addressed in the program agreement between the leasing company and the vendor (or licensor in the case of software):

- Does the lessor have a clear right to terminate the software license and related services if the customer stops paying under the financing documentation? To answer this question, the lessor must carefully review the license documentation and financing documentation.²
- To what extent is the vendor/licensor obligated to perform under the license documentation? Is it clear from the license documentation how much of the cost financed relates to delivered software and how much relates to future deliverables and unperformed future services?
- If the transaction involves the financing of both equipment and software essential to the operation of the equipment, does the lessor have the right to remarket the software along with the equipment?³
- Does the lessor have a clear right to any refund with respect to the software? Usually this is handled by requiring the vendor to purchase the lease or loan from the lessor if a refund is owing to the customer. The vendor can then set off the refund against amounts owing under the lease or loan. Alternatively, the lessor could obtain a perfected security interest in the lessee/licensee's right to a refund under the license agreement and instruct the vendor/licensor to pay any refund directly to the lessor.

Financing Service and Maintenance Fees

The least well understood type of financing is the financing of service and maintenance fees. Having said that, however, it is possible to break down service and maintenance fees into several different categories. Once the different categories of service and maintenance fees are understood, it is possible to identify financing techniques appropriate to each that satisfy the goals of providing financing to the vendor and its customers on the one hand, and providing an acceptable level of risk to the leasing company on the other hand.

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The different types of service and maintenance fees include the following:

- **Services billed on a time and materials basis.** For this type of service fee, the vendor/licensor typically invoices the customer as the services are performed. Payment is normally due within a specified number of days after the date of the invoice. Acceptance certificates may not be obtained from the customer.
- **Services billed upon achieving a specified milestone.** For this type of service fee, an acceptance certificate from the customer may be required. For example, payment may be due from the customer to the vendor/licensor upon achieving a certain level of functionality during the implementation of a system consisting of hardware and software. The lessor may be willing to fund only upon receipt of such an acceptance certificate.
- **Periodic fees.** Some types of service and maintenance fees are billed periodically, for example, annually in advance. This may be the case for standard software bug fixes and sometimes basic telephone support. The annual fee is billed and usually deemed earned whether or not any bug fixes are actually released and whether or not the support is actually used by the customer.

Once the lessor has identified the various types of service and maintenance fees relevant to the particular vendor/licensor, then the lessor can choose from among a number of special financing techniques for financing service fees:

- **Pro rata pass-through.** In this type of financing, the lessor does not fund the service fees to the vendor/licensor up front, but rather pays a pro rata portion of each rental or loan payment to the vendor/licensor. For example, if the initial amount financed is \$1 million, consisting of a \$750,000 license fee and \$250,000 for maintenance services in the first year, the lessor may be willing to pay only \$750,000 up front to the vendor/licensor.⁴ The vendor/licensor would be paid for the services by receiving 25% of each rental or loan payment as the customer makes the payments. This type of

financing may be appropriate for “periodic fees.”

- **Deferred funding.** In this type of financing, the lessor does not fund the services until the services have actually been performed. For example, for service fees that accrue only after the vendor/licensor achieves some specified milestone, the lessor may require an acceptance certificate from the customer as a condition of funding.
- **Evergreen line of credit.** In this example, the lessor provides a line of credit to the customer that, subject to continued credit approval, is renewed annually during a drawdown or implementation period. As equipment is leased, software licensed, and services performed, amounts are advanced, on behalf of the customer, to the vendor/licensor under the line of credit. At the end of the drawdown or implementation period, the outstanding balance under the line of credit is termed out over a 2- to 5-year period. This type of financing can be used for all types of service and maintenance fees.
- **Full recourse to the vendor.** It is always possible for the lessor to finance service and maintenance fees with full recourse to the vendor in the event that the vendor fails to perform. The difficulty here, however, is that there may be limits on the amount of vendor credit risk that the lessor is willing to accept.

In each case, the financing documentation provides the customer with a simple alternative to paying cash up front to the vendor/licensor. From the customer’s point of view, the customer is simply making equal monthly or quarterly payments over a 2- to 5-year period, with perhaps a step-up in the amount of the monthly or quarterly payment in the “deferred funding” model if significant amounts are financed upon achieving certain milestones.

TAKING THE VENDOR PROGRAM GLOBAL—NEW LEGAL ISSUES

When first exposed to the challenge of doing business internationally, a natural reaction is to become overwhelmed by the numerous and var-

ied business practices, customs, languages, and legal systems. Upon closer scrutiny, however, it is apparent that the fundamental issues in a global vendor program are the same as those in a domestic vendor program. Therefore, a well-drafted domestic vendor program agreement can become the foundation for global expansion. Having said that, however, there are a number of new issues to address when documenting the global expansion.

Understanding the Vendor's Global Business Strategy

Perhaps the single most important issue to come to grips with when expanding a vendor program globally is to understand how the vendor's business is structured. In which countries are the vendor's principal operations located? Does the vendor distribute products cross-border from the United States, or does it have local branch offices or distributors located in each country? If the vendor has affiliates in each country, are those affiliates creditworthy? If not, is a parent guaranty available from the parent company in the United States?⁵

Clearly, it is critical to perform careful due diligence on the vendor and to understand the vendor's business. If the intent, however, is to enter into nonrecourse financing where the lessor is looking primarily to the credit of the customer, it may be possible to provide some flexibility to the vendor and accommodate the vendor's global business strategy.

Conflicts with Other Agreements of the Vendor

The lessor should consider seeking a representation and warranty from the vendor to the effect that the global vendor program does not conflict with any other agreements of the vendor. This is usually only a problem for companies that have just recently begun to expand globally. In such a case, for example, the vendor may have a pre-existing credit facility in place that prohibits the creation of subsidiaries; prohibits loans, advances, or contributions of capital to any entity, including, for example, the vendor's local foreign subsidiary; prohibits transactions with affiliates; and prohibits

the vendor or any subsidiary from selling any substantial portion of its assets outside of the ordinary course.

Although a breach by the vendor of such covenants might not affect the lessor's lien position, it is still prudent to identify and deal with such conflicts in advance.

Structuring the Underlying Transaction; Perfection Issues

The law of leasing and secured transactions is very different from one jurisdiction to another. Whether the underlying transaction financing transaction with the customer should be structured as a conditional sale, lease, or secured loan will depend upon the jurisdiction involved and the type of property being financed. The methods of perfection also vary significantly. The good news is that lessors and their advisors have substantial experience in this area.

Foreign Currency

The financing documentation should specify the currency in which payments are to be made. The lessor may want to consider entering into foreign currency hedging agreements to guard against fluctuations in the foreign currency. In any event, if the euro gains acceptance in Europe, it should help to simplify foreign currency issues throughout much of Europe.

Withholding Taxes

Whenever a customer in one country is making payments to a lessor in some other country, the issue of withholding taxes should be carefully considered. The withholding tax rate may, in some circumstances, be reduced or eliminated altogether by a tax treaty between the two countries involved.

Other Taxes

Some jurisdictions have stamp taxes or value-added taxes. Depending on the jurisdiction, it may simply be a matter of allocating the risk of payment of the tax among the parties.⁶ In other cases, it may be possible to avoid the tax liability altogether through careful documentation. For

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example, in the United Kingdom it may be possible to avoid stamp tax on assignments of lease documents by avoiding the use of a written assignment document, but rather having a written offer of assignment that is accepted by conduct, i.e., funding of the purchase price.

Choice of Law

Depending on the country involved and the type of financing, the parties may want to choose to settle disputes under U.S. law or under the laws of the foreign country. For example, if collateral is located in a foreign jurisdiction, then it would be prudent to comply with the laws of the foreign jurisdiction regarding perfection of security interests and enforcement of leases. In some jurisdictions, judgments from a U.S. court are unlikely to be enforced. This would be another example of where it would be prudent to make the laws of the foreign jurisdiction govern the documentation.

On the other hand, it may be feasible to have a guaranty by a foreign subsidiary governed by U.S. law if the guaranty is unsecured and the foreign jurisdiction is one that recognizes judgments obtained in the United States.

Choice of Forum

The issues with respect to choice of forum are similar to choice of law. However, in addition to the location of the forum, the parties should consider whether or not it is more advantageous to resolve disputes by litigation or by arbitration in the particular jurisdiction involved.

SOLUTION—FIRST STEPS TOWARD GLOBALIZATION

Establishing a Global Presence or Global Strategy

As mentioned earlier, not every leasing company is going to open or acquire offices around the world. For some of the larger leasing companies this may be an option, but for smaller lessors a more practical approach may be to establish strategic partnerships or joint ventures with funding sources that already have an established

a global network or with smaller leasing companies in each foreign jurisdiction.

Alternatively, it may be possible to enter into a cross-border lease or financing transaction without establishing a local presence in the foreign country at all. Which option is best will depend on a number of business, tax, and legal issues, which will vary depending on the circumstances, including the following:

- Is it necessary to be licensed in the foreign jurisdiction in order to enter into leases or loan transactions with customers located in that jurisdiction?
- Will the foreign jurisdiction impose a tax on the lessor's worldwide operations if the lessor enters into a cross-border lease from the United States with a customer in the foreign country?
- Will a withholding tax be imposed on the payments if the customer makes payment to a lessor located in the United States?
- In which country will the lease be enforced? Is there a guarantor located in the United States with assets in the United States?

Depending on the answers to these questions in the particular countries involved, the leasing company can decide whether to attempt a cross-border lease or whether it would be better to operate through a local entity in the foreign country. Often it is possible to consolidate operations in certain parts of the world. For example, it may be possible to provide financing throughout most of Europe through a single office located in Europe. Similarly, it may be possible to consolidate operations in the Asia-Pacific region through a single office located in Japan or Singapore.

Assembling a Team of Professionals

Many accounting firms and law firms located in the United States have established networks of specialists worldwide, allowing the leasing company to interface with a single office in the United States. The accounting firm or law firm in the United States can then handle review of accounting and legal issues, respectively, on a global basis.

Creating Standard Form Global Lease and Financing Documentation

Although certain provisions such as choice of law and choice of forum may vary from one jurisdiction to another, the trend is to standardize the lease documentation and vendor program documentation to a large degree. For example, a well-drafted vendor program agreement covering the United States can serve as the foundation for the entire global vendor program.

Most of the key business issues are the same wherever the customer is located. Those issues that are unique to a particular country can be covered in a specific country contract that incorporates the basic terms and conditions from the program agreement covering the United States. This will provide the leasing company with a tremendous marketing advantage when discussing documentation with the vendor who has customers with offices around the world, requesting a single form of lease for all offices.

CONCLUSION

Although at first blush the goal of "going global" may seem to be out of reach, as more and more vendors sell, license, and distribute their products globally, more and more leasing companies will follow suit and provide financing on a global basis. In fact, the growing trend of vendors to conduct business internationally will have two effects. First, it will become necessary for lessors to provide financing on a global basis in order to stay competitive. Second, it will become easier for lessors to provide global financing because of the increased level of uniformity of documentation demanded by vendors.

The starting point is to make sure that there is a solid foundation in the program agreement covering the United States. The basic issues relating to equipment, software, and service fee financing need to be squarely addressed. Then the unique international issues can be covered in specific country contracts that incorporate the basic terms and conditions of the U.S. program.

Clearly, those lessors who start now to address the issues of going global will be ones to reap the rewards in the new millennium.

The author's biography may be found on page 32.

Endnotes

¹ William S. Veatch, "Software Leasing: The Intricacies of the Intangible," *Journal of Equipment Lease Financing*, Vol. 14, No. 2 (Fall 1996) for an overview of some of the different structures used to finance software. See also, William S. Veatch, "Software Financing: The Perplexities of a Program Agreement," *Journal of Equipment Lease Financing*, Vol. 15, No. 2 (Fall 1997) for a discussion of software vendor programs.

² In the worst case scenario, the license is not cross-defaulted to the financing documentation. This can often happen, for example, where the leasing company provides financing directly to the customer, as opposed to taking an assignment of financing documentation originated by the software licensor. If this happens, the leasing company may not have an enforceable right to terminate the software license in a bankruptcy of the lessee/licensee unless it has the status of a secured creditor. The law is unclear in this area at the present time.

³ In technical terms, in a mixed equipment/software financing where the software is essential to the use of the equipment, the vendor/licensor should agree to license the software to a substitute lessee pursuant to its then current standard license. The license fee to the substitute lessee might, however, be reduced or waived altogether.

⁴ Often the lessor will be willing to fund at least one year of maintenance in advance. There can, however, still be an issue in the case of a bankruptcy of a lessee/licensee. For example, if the licensee goes bankrupt, can the lessor get a pro rata refund of the prepaid maintenance? The answer depends on a careful review of the documentation.

⁵ Sometimes a guaranty is not available from the vendor's perspective because of tax issues that could result from the cross-border guaranty.

⁶ For example, in Canada there is a federal goods and services tax that is imposed in addition to a provincial sales tax.

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