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**PAYMENT MECHANISMS IN INTERNATIONAL TRANSACTIONS**

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## **INTRODUCTION\***

A key aspect of any commercial arrangement is the means of payment between the parties. This paper addresses the most salient elements of payment mechanisms in three types of international transactions: distribution arrangements, franchise agreements, and continuing sales transactions. The paper covers payment arrangements for commercial relationships only, and not for consumer transactions.

The paper covers a variety of issues related to payment. These include contractual payment terms; the timing for payment; and currency fluctuation and hedging issues. The paper also addresses the increased use of electronic payments, such as online banking, internet payments, and other similar types of payment mechanisms, as well as the availability of electronic payment through national banking systems. It also addresses various types of third-party payment mechanism such as the use of letters of credit and guarantees, as well as regulatory issues arising in selected countries and regions of the world. Finally, the paper addresses payment issues in cases of insolvency of one of the parties.

## **TYPES OF PAYMENT ISSUES**

Contracts for distribution arrangements, franchise relationships, and long-term sales transactions will typically contain precise payment terms that set forth the types of payments that are required under the contract, the timing and methods of making payment, and the persons or entities that have primary and secondary liability for making such payments. A general description of these terms is discussed below.

### **A. Types of Payments**

The payments due under an agreement depend, of course, on the type of agreement. Franchise agreements (and sometimes distribution agreements) will typically have both initial, or upfront, payments and ongoing payments, such as royalties. The initial fees are designed to compensate the franchisor for its upfront investment, in terms of both time and money, in assisting the franchisee with training and opening the business. Royalties, on the other hand, are a fee for the franchisee's ongoing use of the franchisor's trademarks as well as any ongoing assistance provided by the franchisor. Payments made under distribution and sale agreements are primarily for the purchase of the goods being sold but, depending on the distributor's other obligations, and services rendered by producer, payments for cooperative marketing, promotion, and use of trademark can be included. The contract may require minimum purchases to be made on a consistent, periodic basis, or permit the distributor/purchaser to make purchases on an as-needed basis. Payment may be

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required, and may be guaranteed by various mechanisms, even if the minimum amount is not ordered.

## **B. Timing of Payments**

The timing for making payments will depend in large part on the type of payment being made. An initial, or upfront, payment will typically be due upon, or prior to, the execution of the contract. However, the payee may agree to receive payment of an initial fee in installments, with or without interest. Ongoing fees, such as royalties, are normally due on regular intervals, such as weekly, monthly, or quarterly. For purchases of goods pursuant to a distribution or sales agreement, payments may be due, or the time period for payment may commence, at the time of the order, prior to delivery of the goods, upon receipt of the goods, or upon receipt of an invoice for the goods. As indicated above, orders for goods may be required on a regular basis or on an as-needed basis, with minimum purchases and/or inventories sometimes required. In all cases of delayed payment, there is a risk that the payor and payee's currencies will fluctuate in value, necessitating consideration of hedging strategies detailed later in this paper.

## **C. Methods of Payment**

A contract will normally require payment by specific means, such as check, credit card, direct deposit, or electronic fund transfer. While many countries still rely on paper-

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based transactions, more and more are turning to electronic banking. The obvious disadvantage of paper banking is the delay in the transfer of funds. Although international credit cards allow for a more immediate transfer of funds, there are typically third party fees that must be paid to the credit card issuer. Therefore, direct bank deposits and electronic fund transfers (“EFTs”) have become the preferred method of payment for most international franchise, distribution, and sale agreements, based both on the speed of the transfer of funds and the low cost.

The Society for Worldwide Interbank Financial Telecommunication (“SWIFT”) has made international electronic payments easier and more secure. SWIFT enables the secure exchange of financial information among all of its over 8,000 financial institutions in more than 200 countries. By providing a platform for the secure and reliable exchange of financial information, it facilitates electronic banking in the international community. SWIFT also facilitate the communication of letters of credit to confirming or advising banks. The engagement of a bank under a letter of credit may serve as the primary, expected means of payment, or as a secondary means more in the nature of a guarantee.

#### **D. Liability for Payments**

Payments under any contract are principally the obligation of the contracting party who receives the goods or services for which payment is required. The contracting party may be an individual or a corporation. For individuals or groups of

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individuals, those parties may be required to have guarantors, such as their spouses, who would be jointly and severally liable for all payments under the contract. If the contracting party is a corporation or other entity, then the individual owners (as well as their spouses) are often required to personally guarantee all payments under the contract. If a subsidiary corporation is entering into a contract, the franchisor/seller may also require the subsidiary's parent corporation to sign a guarantee. Finally, insolvency issues may interfere with payment obligations.

#### E. Letters of Credit

A Letter of Credit is an engagement to deliver payment upon fulfillment of a condition. Under the Uniform Customs and Practice for Documentary Credits<sup>1</sup> (UCP), a credit is defined as “any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honor a complying presentation.”<sup>2</sup> Commercial laws at a national level give similar definitions.<sup>3</sup>

Although letters of credit can be revocable or irrevocable, nearly all letters of credit are issued in irrevocable form. In practice, beneficiaries insist on an irrevocable letter of

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<sup>1</sup> Uniform Customs and Practice for Documentary Credits published by the International Chamber of Commerce (ICC). The latest version is UCP 600, effective July 1st, 2007.

<sup>2</sup> UCP 600 Article 2.

<sup>3</sup> In the United States, the definition is found in the Uniform Commercial Code (U.C.C.) § 5-102(1)(a): “‘Credit’ or ‘letter of credit’ means an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article (Section 5-102) that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honor or a statement that the bank or other person is authorized to honor.”

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credit to ensure financial commitment of the bank. The UCP presumes irrevocability and treats a credit as “irrevocable even if there is no indication to that effect.”<sup>4</sup>

The letter of credit has a long history as a payment mechanism for international business. By its nature a letter of credit is a separate transaction from the sales or other underlying agreement between the parties. Issuing banks are not concerned with the performance of the contract.<sup>5</sup>

### **1. Types of Letter of Credits**

The most common types of letters of credit today are the commercial letter of credit and the standby letter of credit. They differ largely in the role that the letter of credit plays in securing the expectations of the parties in performance of the underlying contractual obligation. In the simplest possible terms, a commercial letter of credit provides the *expected* means of payment, while a standby letter of credit is expected to be drawn on only in the event of default by a party to the underlying transaction.

### **2. Commercial Letter of Credit**

In a commercial letter of credit transaction, the issuing bank commits up front to pay a specified amount of money to the beneficiary when presented with a specified set of documents. In the most common setting, the beneficiary does not have to rely on the buyer’s promise to make payment when due for goods. Rather, the beneficiary (seller) only has to provide the required documents to receive payment from the issuing bank.

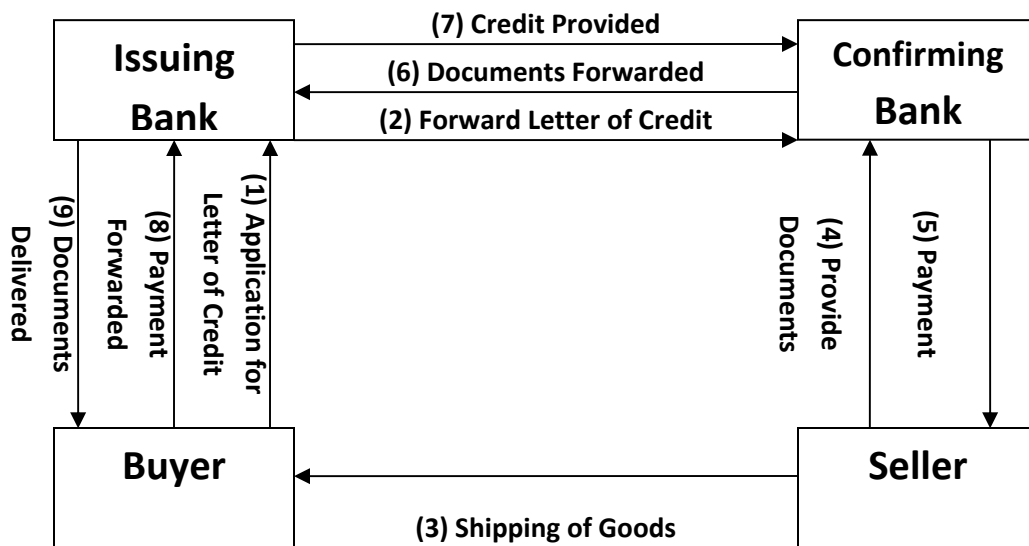
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<sup>4</sup> UCP 600 Article 3.

<sup>5</sup> UCP 600 Article 4.  
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This allows a shift of the risk involved in the transnational transaction. The beneficiary is to receive payment from the bank once the required documents are rendered. Thus, the beneficiary can rely on the direct obligation of the issuing bank as well as any confirming bank, in addition to the contractual liability of the buyer.<sup>6</sup>

The illustration below illuminates the main steps in a transaction using two banks.



A letter of credit is not a guarantee of payment. It is an undertaking to exchange payment for specified documents upon the terms stated in the letter of credit and any terms incorporated therein, such as the UCP. The beneficiary will only receive payment if the documents presented comply exactly with the requirements of the letter of credit. Banks will only accept documents that exactly match the requirements and the

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<sup>6</sup> A confirming bank adopts the issuing bank's obligation to make final payment upon fulfillment by the beneficiary of the letter of credit's requirements and owes an independent duty to the beneficiary. UCP 600, Article 12.  
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language of the letter of credit.<sup>7</sup> Even the misspelling of the beneficiary's name on the letter of credit may allow the bank to deny payment.<sup>8</sup> Under the U.C.C. the beneficiary has the duty to inspect the letter of credit and is responsible for any negligent failure to discover that the letter of credit does not achieve the desired result.<sup>9</sup>

### 3. Standby Letter of Credit

A standby letter of credit is based on the underlying principle of letters of credit that payment is made against presentation of documents, but those may be whatever documents the applicant, beneficiary, and issuing bank agree to, not necessarily shipping documents.

Standby letters of credit are often used to reduce the risk that a party to the contract will default or not perform its obligations. In order to receive payment, most standby letters of credit require only a presentation of documents as simple as a certificate from the beneficiary stating that the applicant has failed to perform.

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<sup>7</sup> *JH Rayner and Company, Ltd. v. Hambros Bank Ltd.*, Court of Appeal, [1943] 1 K.B. 37 [bank was not required to honor the letter of credit where the documents required "Coromandel groundnuts" but the presented documents referred to "machine-shelled groundnut kernels", although testimony showed those words referred to the same goods].

<sup>8</sup> *Hanil Bank v. Pt. Bank Negara Indonesia* (S.D.N.Y. 2000) 41 U.C.C. Rep. Serv. 2d 618 [bank may refuse payment to intended beneficiary Sung Jun where beneficiary's name had been misspelled in letter of credit as "Sung Jin"].

<sup>9</sup> *Mutual Export Corp. v. Westpac Banking Corp.*, 983 F.2d 420, 422 (2d Cir. 1993).  
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## **PAYMENT MECHANISMS IN INDIA\*\***

Payment systems of a country constitute an important element of the financial sector infrastructure, and are essential for the proper functioning of economies. In India, the payment system ranges from paper based instruments to the most upcoming Electronic Fund Transfer systems offering real time settlements. Several trade regulations framed from time to time ensure the safety, soundness and efficiency of the market infrastructure and assist in the development and maintenance of foreign exchange market in India. The Reserve Bank of India (“RBI”) is the key authority that regulates payments made in any form either to or from India, setting credit limits for the nature of permitted transactions as well as in cases of remittances allowed or prohibited as the case may be.

### **A. ELECTRONIC PAYMENTS:**

The payment system in India continues to be dominated by paper-based transactions but there is great potential for a transition to electronic payments. India has witnessed unparalleled growth in payment systems since the initiation of electronic payment infrastructure. Recognising the importance of ensuring the safety and security of the payment systems, RBI has taken major initiatives to upgrade and modernise this system in India and has hence put forth various modes of electronic payments i.e. Real time Gross Settlement (“RTGS”) System, National Electronic Fund Transfer (“NEFT”) System and Electronic Clearing Service (“ECS”). However, these services offered by the banks are available for operations within the country and payments through these modes have been steadily growing in the last few years.

There is an upsurge in the number of international transactions between Indian residents and foreign entities. Liberalisation of foreign exchange policy has given boost

to the cross border trade as also miscellaneous buy and sell transactions of various products and services. While remittance through authorised dealers i.e. banks licensed by the Reserve Bank of India to deal in foreign exchange, is the most prevalent payment, of late, modern payment techniques such as internet transfers and payments through e-vaults and International credit cards are gaining momentum and are as frequently done in the domestic market.

- **Different Forms of Electronic Payment Systems**

- **Internet Banking**

Working Group on Internet Banking appointed in 2001 by the RBI had made certain recommendations in the context of internet banking, which were made to be applicable, in general, to all forms of electronic banking, to the relevant extent.

As per these recommendations, no prior approval of the RBI was required and banks were permitted to offer internet banking facilities based on the Board-approved internet banking policy. Banking products offered through internet banking are open to local currency products as also foreign exchange services, for the permitted underlying transactions. Operations on the Vostro accounts of the overseas banks and exchange houses, maintained with the banks in India, are also permitted through the internet-based operations.

- **International Credit Card**

Use of International Credit Cards (“ICCs”) / ATMs/ Debit Cards is allowed under the current Indian regulations. ICC may be used for making personal payments like subscription to foreign journals, internet subscription, etc., and for travel abroad in connection with various purposes. The entitlement of foreign exchange on ICCs is limited by the credit limit fixed by the card issuing authority only. With ICCs one can (i) meet expenses/make purchases while abroad (ii) make payments in foreign exchange for purchase of books and other items through internet in India. A person

having a foreign currency account in India or with a bank overseas can obtain ICCs of overseas banks and reputed agencies.

- **Availability of Electronic Payment Through National Banking Systems**

- **Asian Clearing Union (ACU)**

Considering mechanisms for international transactions, the Asian Clearing Union (“ACU”) system was introduced. It facilitates settlement of monetary transactions among the member countries of the Union and provides a system for clearing payments among these member countries on a multilateral basis. The central banks and monetary authorities of Iran, India, Bangladesh, Bhutan, Nepal, Pakistan, Sri Lanka and Myanmar are the members of the ACU.

RBI requires all eligible transactions enumerated by it, to be compulsorily settled through the ACU mechanism.

To effect payment through the clearing facility, the instruments of payment are denominated in Asian Monetary Unit - AMUs which is the common unit of account of the ACU (ACU dollar and ACU euro). The Authorised Dealers (“ADs”) in India are permitted to handle ACU transactions in the same manner as any other foreign exchange transactions. They are also consented to freely enter into correspondent arrangements with banks in the other member countries.

RBI records any payment made or deposit received in US Dollars (“USD”) in the ACU account. These payments facilitate funding or repatriating the excess liquidity in the ACU dollar accounts that are maintained by the ADs. In addition to this, RBI also receives or delivers USD that helps to absorb liquidity or to fund the ACU dollar (vostro) accounts that are maintained by the AD on behalf of their overseas

correspondents. Thus, this system facilitates payment arrangements whereby the member countries settle payments for current international transactions among themselves.

- **SWIFT**

The Society for Worldwide Interbank Financial Telecommunication (“SWIFT”), which is a cooperative society, governed by the Belgian law, is a system used by banks across the world for secure messaging of international fund transfers. It is not a payment system by itself, but enables the exchange of financial information (payments, securities orders, reporting) with all its financial institutions through one highly secure, standardized communication platform, as opposed to multiple connections. SWIFT has 9 types of Standard Message Categories including various message types for specific uses.

A majority of the forex related messages are sent to correspondent banks abroad through SWIFT. The users of this network in India are the RBI, all major banks including the newly established private sector banks, branches of foreign banks and major financial institutions.

## **B. LETTERS OF CREDIT**

### **Letters of Credit**

The Letter of Credit (“L/C”) is considered as one of the most convenient methods for settlement of payments in international trade. It is a guarantee in the form of a contract between the buyer and seller, which ensures settlement through documentary letter of credit. Issues relating to import of goods in India, payments made thereof, credit norms, etc are governed by the following:

1. Uniform Customs and Procedures for Documentary Credit (“UCPDC”)
2. Trade Control Regulations

3. EXIM policy, Import Trade Control
4. Foreign Exchange Management Act (“FEMA”)
5. Reserve Bank of India (Directives & Credit Norms)
6. Foreign Exchange Dealers Association of India (“FEDAI”)
7. Internal Guidelines of the banks

### TYPES OF L/Cs

Depending upon the nature and function of credit granted, L/Cs are categorized as follows:

○ Confirmed/Unconfirmed L/C

A confirmed L/C is the one that bears an undertaking of not only of the bank issuing credit, but also of another bank. Unconfirmed L/C will bear only the guarantee of the issuer and no undertaking given by any bank.

○ Transferable/Divisible L/C

A transferable L/C can be transferred at the request of the original beneficiary to any second or several beneficiaries subject to terms and conditions specified in the original documentary. The credit can also be transferred partially subject to the availability of division and partial shipment.

○ Deferred payment L/C

Where a portion of the value of goods or services is payable on deferred terms or instalments it is known as deferred payment credit. (along with agreed rate of interest). In India, establishing Deferred payment L/C requires prior approval of the RBI.

○ Revolving L/C

Instead of arranging for separate L/Cs for multiple shipments, the buyer arranges for a single L/C by virtue of which it enables him to enter into an agreement for purchase of goods over a long period with a condition of periodical shipment.

- Anticipatory Credit

An arrangement in favour of the beneficiary that grants him part or full amount of the value of goods or services in the pre shipment stage, in anticipation of the actual shipment and submission of final documents at a specified date in future. This is provided to him by the beneficiary's bank, which is later on settled against the final amount with the other party's bank.

- Back to Back Letter of Credit

Such type of countervailing credit is established to assist the exporter who is not willing to disclose the name of the actual supplier of goods. A L/C is first established by the importer, in favour of the exporter who acts as an intermediary. Against the security of this credit provided, the exporter establishes another L/C in favour of the original supplier. This should be established only against Irrevocable L/C to prohibit any amendment or cancellation at a later date.

- Standby L/C

A standby L/C can be established only against import of goods. RBI permits ADs to issue standby L/C for imports permitted under the Foreign Trade Policy. Importers are advised to prefer documentary credit governed by UCP 600, as, the facility for issuing standby L/C is done on a selective basis and only to a certain class of importers. It is mandatory for banks to fix separate credit limits for standby L/Cs to assess the risk involved, and inform the importer of the inherent risk accordingly. It is however payable on first demand in the event of any non-performance of obligations. The operational procedure of standby L/C is governed under the guidelines of FEDAI. In case a stand by L/C under International Standby Practices (ISP) 98 is established through SWIFT, a specific clause pertaining to the same should be included.

## **C. GUARANTEES**

A contract of guarantee represents an authorized undertaking to perform a given obligation, which may be in the form of payment of debt or performance of a contract. Guarantees are common in export or import transactions. As such, they undertake to compensate or make good the pecuniary loss suffered by the creditor subject to the extent of amount agreed upon.

A bank guarantee operates in the same business context as a standby letter of credit, that is to say, it is payable when first demanded, against presentation of a written declaration that the required conditions have not been complied with. A bank guarantee constitutes as one of the most important instruments when there is a need to manage ones international purchases or to avail of easy terms of trade finance. Sometimes, it is difficult for the buyers to assess the ability of the overseas suppliers to produce goods as ordered, or to provide reimbursement in case of any default as per contract. Bank guarantees in such cases provide protection to importers ensuring smooth performance of the said contract, in the event of infringement of its terms.

### **Types Of Bank Guarantees In Foreign Trade**

#### **(i) Export Guarantee**

- ♦ An export guarantee may be in form of a *Bid Bond Guarantee*, which is used to secure the claims made by the party inviting tenders, in the event of withdrawal of such bid or in the event where the tenderer refuses to sign the contract after being awarded the contract.
- ♦ Banks also issue *Performance Guarantees* to secure warranty obligations or to meet contractual obligations. These may be extended to overseas purchasers/agents/banks or in some cases the Export Promotion Council/State Government or any other parties related.



- ♦ An *Advance Payment Guarantee* to overseas buyer gives him safeguard against any advance payments made to the exporter and ensures reimbursement in the event of default by the exporter or failure to meet his contractual delivery obligations in full.
- ♦ Banks also issue guarantees for *Warranty Obligations*, in favour of the overseas buyer in the event of any possible defects appearing after the delivery of the goods.
- ♦ *Delivery guarantees* used to secure timely delivery of the shipment to overseas importer thus ensuring that in the event the seller does not meet his obligations, the buyer will be entitled to claim compensation under the guarantee.

## **(ii) Import Guarantee**

Guarantees to pay the customs can be issued by banks for temporary imports into the country. As per FEMA Regulations, AD-I category of dealers are permitted to issue guarantees on behalf of their importers, subject to the nature of transaction and credit limit specified therein.

## **(iii) Other Guarantees**

- ♦ Banks may issue guarantees *on behalf of* their overseas constituents/branches, provided counter guarantees are provided.
- ♦ Bank Guarantees favouring the *RBI or Government of India* may also be given.
- ♦ *Payment guarantees* undertake to make prompt payment to the exporter and secure any other claims made thereof on the buyer.
- ♦ Payments that have been deferred or postponed are ensured by *Deferred Payment Guarantees*. It also aids payments due on instalment basis under the deferred payment terms.
- ♦ *Financial guarantees* can be availed of for contracts entered into by the customer, which require earnest money or cash to be deposited for their performance.

- ♦ *Minor guarantees* are given on behalf of customers/overseas branches in respect of any documents that are missing/defective or authenticity of signatures.

Banks providing financial or performance guarantees in case of high value project exports need to safeguard their interests in case of default by the exporter. Such banks can avail of guarantees given by *Export Credit Insurance and Guarantee Corporation of India Limited (ECGC)*, which provides guarantees to banks against the risk involved in extending credit facilities to exporters, or confirmations given with respect to letters of credit, insurance to cover buyer's credit, lines of credit, joint ventures and overseas investment.

An international guarantee is not governed by any particular legal regulation, but it can be issued by ADs as also persons other than ADs. The set of laws explained under *Foreign Exchange Management (Guarantee) Regulations, 2000* ("**the Guarantees Regulations**") lay down the extent and the circumstances under which such guarantees can be issued.

#### a. Corporate

As per the Guarantees Regulations, a person resident in India is prohibited from giving any form of guarantee, which has the effect of guaranteeing, a debt, obligation or other liability owed by a person resident in India to, or incurred by, a person resident outside India except in certain stipulated cases or with permission of RBI.

#### b. Personal

The prohibition as contained in the Guarantees Regulations, will equally apply to the personal guarantees and accordingly, a resident individual is prohibited from giving any form of guarantee in favour of a person resident outside India except with general or special permission of RBI.

c. Others

In terms of the Guarantees Regulations authorized dealers (banks) are allowed to issue guarantees in certain cases.

The Guarantees Regulations however permit issue of guarantees in the following cases.

**Guarantees given by Authorised Dealers:**

1. An AD may issue a guarantee in respect of any debt, obligation or other liability incurred by a **person resident in India** and **owed to a person resident outside India** in case he is an
  - Exporter on account of the exports;
  - Importer in respect of import on deferred payment terms subject to RBI's permission for the same.

A guarantee may be given in the form of a Letter of Undertaking/Letter of Comfort in favour of the overseas supplier, bank or a financial institution. A guarantee or a standby Letter of Credit can similarly also be issued in connection with the payment of margin money in respect of approved commodity hedging transactions of the person resident in India. The Reserve Bank of India subject to the Foreign Trade Policy and guidelines issues this from time to time.

2. Similarly, the AD may issue a guarantee in respect of any debt, obligation or other liability incurred by a **person resident outside India** and **owed to a person resident in India:**
  - With respect to bona fide transactions provided such transactions are covered by counter-guarantee of a reputed international bank resident abroad;
  - As a counter-guarantee with respect to the guarantee issued by his branch or correspondent outside India, on behalf of Indian exporter to overseas buyer.

3. The AD may also **in the ordinary course of his business** give a guarantee:

- On behalf of his customer/branch/correspondent outside India with regards to any missing or defective documents, or authenticity of signatures;
- In favour of organizations outside India for holding their traveller's cheque for sale in India;
- In favour of foreign airlines/ International Air Transport Association ("IATA"), on behalf of IATA approved travel agents;
- In favour of a non-resident service provider, on behalf of a service importer resident customer, for an amount up to USD 100,000 or its equivalent.
- On behalf of a company in India promoting or setting up outside India, a joint venture company or a wholly owned subsidiary in connection with its business provided that the terms and conditions for promoting or setting up such company or subsidiary are continued to be complied with.

### **Guarantees given by persons other than Authorised Dealers**

Persons other than those authorised to give guarantees are permitted to issue guarantees in the following case:

- a. An exporting company in India may give a guarantee outside India either for performance of a project outside India or for availing credit facilities, provided relevant approvals for such a project has been obtained from the Approving Authority<sup>10</sup> in India.
- b. An exporting company in India may also give a guarantee in lieu of Bid Bond Guarantee for bidding a contract outside India. This may be given without

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<sup>10</sup> Approving Authority as per Foreign Exchange Management (Export of Goods and Services) Regulations, 2000 means the Working Group (Group constituted by the Reserve Bank for the purpose of considering proposals of export of goods and services on deferred payment terms or in execution of a turnkey project or a civil construction contract) or the EXIM Bank or the authorised dealer.  
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approval of the Approving Authority, provided, that the amount of such guarantee does not exceed 5% of the contract value.

- c. A company in India, in compliance with the regulations given under Foreign Exchange Management (Transfer and Issue of Foreign Security) Regulations, 2000 may issue a guarantee for promoting or setting up a joint venture company or a wholly owned subsidiary, outside India.
- d. An agent in India of an airline or a shipping company which is incorporated outside India, may give a guarantee, on behalf of such company with respect to any obligation or liability owed by it, to any statutory or Government authority in India.
- e. An Authorised Dealer Bank subject to conditions issued by the RBI, may permit a person resident in India to issue a guarantee in favour of an overseas lender or security trustee to secure an external commercial borrowing that is availed under the provisions of Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000.

## **D. OTHER REGULATORY ISSUES**

### **1. The Foreign Exchange Regulations**

Sections 5 and 6 of the FEMA deal with “Current Account Transactions” and “Capital Account Transactions”. Current Account Transactions means transactions other than capital account transactions and such transactions include -

- (i) payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business;
- (ii) payments due as interest on loans and as net income from investments,

(iii) remittances for living expenses of parents, spouse and children residing abroad, and

(iv) expenses in connection with foreign travel, education and medical care of parents, spouse and children.

Foreign Exchange Management (Current Account Transactions) Rules, 2000, provide for certain transactions for which drawal of foreign exchange is prohibited and approval of either Central Government or RBI is necessary. For all other current account transactions which are not specifically prohibited, remittance is permitted without any ceilings.

“Capital Account Transaction” means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub-section (3) of Section 6 of FEMA.

Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000 provides for classes of permissible Capital Account Transactions by person resident in India and person resident outside India.

Schedule I of the Current Account Transactions Rules prohibits remittance for certain transactions such as remittance out of lottery winnings, remittance for purchase of lottery tickets, football pools, sweepstakes etc. Schedule II of the Current Account Transactions Rules requires approval of the Central Government inter alia in case of In case of technology collaboration if the payment of royalty exceeds lumpsum payment upto US\$ 2 million and royalty upto 5% for domestic sales and 8% for exports. As per Schedule III, in certain cases such as medical treatment, foreign visit for employment, if the amount exceeds certain thresholds approval of the RBI is required. For all current account transactions, (except those which are prohibited or for which approval of Central Government or RBI is necessary), remittances are permitted without any ceilings.

## **2. Foreign Exchange Management (Manner of Receipt and Payment) Regulations, 2000**

RBI has set out regulations governing permitted currencies and methods of payments to be used for settlement of financial transactions between residents and non-residents through ADs in Foreign Exchange Management (Manner of Receipt and Payment) Regulations, 2000.

The permitted currency indicates a freely convertible foreign currency (a currency which is permitted by the rules and regulations of the country concerned to be converted into major reserve currencies)

- **Manner of Receipts and Payments for member nations of ACU**

AD banks in India are allowed to open and maintain ACU Dollar and ACU euro accounts with their correspondent banks in other participating countries to settle eligible payments for transactions between member countries in the ACU (except Nepal) i.e. Bangladesh, Islamic Republic of Iran, Myanmar and Sri Lanka. For other transactions, payments in any permitted currency may be made. The same applies to Pakistan in case of imports.

For all other countries payments are allowed to be made in rupees to/from the account of a bank situated in a country other than a member country of ACU, Nepal or Bhutan or it can be made in any permitted currency while for Myanmar, payment is permitted to be made in any freely convertible currency or through the ACU mechanism.

As far as the exports are concerned, payment must be received in a currency appropriate to the place of final destination as mentioned in the declaration form irrespective of the country of residence of the buyer, while in cases of other imports; payments are to be received in a currency appropriate to the country of shipment of goods.

- A Buyer can also make payment to the Exporter by way of a bank draft, cheque, pay order, foreign currency notes, and traveler's cheque during his visit to India, or out of

the FCNR/ NRE accounts maintained by him, credit cards, or precious metals by the Gem & Jewellery units in SEZs & EOUs subject to certain conditions. In case of imports payments are also allowed to be made through international credit cards.

- RBI has issued directions for payments where the exports/ imports are arrangements between the Central Government and government of a foreign state subject to compliance with required regulations and the export import policy.

### **3. Trade Credit Mechanism**

The concept of Trade Credits refers to credit extended by an overseas supplier, bank or any financial institution to the importer, with respect to imports in India. These are governed by the extant provisions of the External Commercial Borrowing Guidelines (“ECB Guidelines”) issued by the Government of India. If the period of credit extended is three years or more, the same be treated as an *External Commercial Borrowing (“ECB”)* and will be governed by the ECB Guidelines.

AD banks in India are permitted to approve trade credits extended up to USD 20 million per import transaction for:

- Import of non capital goods permissible under the current Foreign Trade Policy with a maturity period of one year from the date of shipment; and
- Import of capital goods with a maturity period of more than one year but less than three years from the date of shipment.

Timely details of the same are required to be reported by the authorised dealers in a consolidated form to the RBI.

In terms of the ECB Guidelines as applicable to Trade Credits, guarantees in the form of Letters of Credit (“L/C”)/Letter of Undertaking (“LoU”) /Letter of Comfort (“LoC”) can be issued by such banks in favour of the overseas supplier, bank or



financial institution Also, such guarantees/ LoU / LoC / L/C are required to be co-terminus with the period of credit, reckoned from the date of shipment.

#### **4. Liberalised Remittance Scheme (LRS)**

The RBI introduced Liberalised Remittance Scheme (“LRS”) to facilitate overseas investments by resident individuals. It is a step towards liberalization of the foreign exchange facilities available to resident individuals. Under the LRS, a person resident in India is allowed to remit up to USD 200,000 per financial year for any permitted capital or current account transactions or a combination of both. The limit of USD 200,000 under the Scheme also includes remittances towards gift and donation by a resident individual. Resident Indians are allowed to open accounts abroad and make a transfer up to this limit without seeking RBI approval under the LRS and the same can also be used to invest in units of Mutual Funds, Venture Funds, unrated debt securities, promissory notes etc

However, all other transactions, which are otherwise not permissible under the Foreign Exchange Management Act and those in the nature of remittances for margins or margin calls to overseas exchanges/ overseas counter party, are not permitted. It is also pertinent to note that Banks are not consented to extend any kind of credit facilities to resident individuals to facilitate remittances under the Scheme.

#### **5. Payments under Franchise Transactions & Technical Collaborations**

##### **Franchise Payments:**

Normally, a franchise arrangement would involve payments such as franchise fee, royalty for use of trade marks and system, training expenses, advertisement contributions, etc. If such payments are to be made to a foreign franchisor the provisions of the Current Account Transactions Rules will apply as per which such payments are allowed to be remitted without any approval requirements.

**Payments for use of Brand Name (otherwise than under Franchise arrangement):**

In case of use of the foreign collaborator's brand name or trade mark, without transfer of technology, royalties up to 1% for domestic sales and 2% on exports are allowed under the automatic route i.e. without requirement of any approval. Payment of amounts in excess of these limits will require prior approval of the government.

**Payments for Technical Collaboration:**

FEMA also permits payment of lump sum of US \$2 million and royalties of 5% on domestic sales and 8% on exports by Indian residents to their foreign counterparts for use of foreign technology. Amounts in excess of this may also be remitted after seeking permission of the government.

Normally, payments as above, are made by Indian parties to the foreign counterparts through the authorised dealers in India via SWIFT mode. At times letters of credit are used to make such payments

**Guarantees to secure Payments**

Quite often the foreign franchisor or the technology provider may ask for guarantee of the promoters or principal shareholders of the Indian party to secure payment of royalty amounts. As mentioned above, in terms of the Guarantee Regulations, such guarantee can be issued only after obtaining prior approval of the Reserve Bank of India. The approval is granted on case to case basis depending on the nature of facts and merits.

## **REGULATORY FRAMEWORK FOR NEW PAYMENT MECHANISMS**

### **IN THE EUROPEAN UNION\*\*\***

To date, the European Union consists of 27 Member States. In 1999, the Euro was introduced as the common currency in the European Union. However, not all members of the European Union are also members of the European Monetary Union. In order to accede, the economies in question have to fulfill the convergence criteria (also referred to as Maastricht Criteria), which not all economies are capable of achieving at the moment. Although some states would fulfill the criteria, they are unwilling to join for political considerations. Hence, out of 27 Member States of the European Union, at the moment, only 16 are members of the Monetary Union. Major Member States, such as the United Kingdom or Sweden, have not acceded to the Monetary Union due to general political considerations, while others like the Baltic States are not able to fulfill the Maastricht Criteria yet.

Although most of the European Union Member States have a common currency since the introduction of the Euro, non-cash payments from one Member State to another were still treated as cross border payments rather than domestic payments by the banking sector. The disadvantage for participants in such payment transactions, for the payer and the payee, regardless if they were consumers or entrepreneurs, was that they were charged higher fees for cross-border payments and that payments took much longer from the moment the transaction was placed with the bank until it was actually credited to the beneficiary's account.

In order to establish the Euro Area, also called Euro Land/Zone, as a true single market with regard to the financial sector, the political institutions of the European Union, together with the European banking sector, took the initiative to create the Single Euro Payment Area (abbreviated as SEPA). The intent and purpose of SEPA is that the European public economy in the Euro Zone may fully exploit the benefits of the Economic and Monetary Union.

To create the Single Euro Payment Area, technological and organizational measures had to be taken and legal frameworks had to be amended. In order to coordinate these technical and organizational changes, a decision-making body was set up, namely the European Payments Council (<http://www.europeanpaymentscouncil.eu>). The existing Directive 2560/2001/EC on cross-border payments was supplemented by the new Payment Service Directive 2007/64/EC.

To create the Single Euro Payment Area, new payment instruments have been developed. These are mainly the tools of SEPA-credit transfer, SEPA-direct debit and SEPA-card payment. When the instruments of SEPA-credit payment and SEP-direct debit were created, it was decided to replace the existing credit transfer and direct debit regulations with a single new instrument for Euro payments. For card payments, an “adaption”-strategy was chosen, to allow existing schemes and their operators to adjust to a new set of business and technical standards and processes.

But the efforts of the regulator and the banking industry go beyond the creation of new payment mechanisms. Already before it comes to any payment an electronic invoice shall enable that bills are sent directly to the payer’s internet banking application, and once the payer has accepted the bill, an automatic payment instruction is created containing the relevant information on the payer and payee. The ultimate goal is to create an “End-to-end straight-through processing” (e2e STP).

Credit Transfer is a payment initiated by the payer. In a credit transfer, a payment instruction is sent to the payer’s bank (i.e. the sender’s bank) which moves the funds to the payee’s bank (i.e. the receiver’s bank), possibly via several intermediaries.

SEPA-credit transfers stand out for the fact that they are accessible throughout the whole SEPA-zone. The entire amount is credited to the beneficiary's account. There is no limit on the value of payments. The maximum settlement time is three business days (as of 2012: one day). IBAN (International Bank Account Number) and BIC (Bank Identifier Code) are used as account identifiers. There is a comprehensive set of rules for dealing with rejected and returned payments.

Direct debit is a transfer initiated by the payee (i.e. the recipient) via the payee's bank following an agreement between the payee and the payer (i.e. the sender). Direct debits are often used for recurring payments (such as utility bills), but may also be used for one-off payments where the payer authorizes an individual payment. The prerequisite for direct debits is in any event the prior authorization by the payer.

SEPA direct debit is also available throughout the entire SEPA-zone. There is a maximum settlement time of five business days for one-off payments or the first in a series of recurring payments and of two business days for the following recurring payments. IBAN and BIC are used as account identifiers as well. SEPA direct debit is also accompanied by a comprehensive set of rules for dealing with rejected and returned payments.

As for card payments, one has to differentiate between debit card payments and credit card payments. Debit cards enable the cardholder to charge purchases directly and individually to an account. Credit cards on the other hand allow the cardholder to make purchases within a certain credit limit. The balance is either settled in full by the end of a specific period or settled by installments. As was already mentioned above, the general structure of card payments was not newly defined by SEPA or the Payment Service Directive but instead an existing infrastructure was used.

The Payment Service Directive not only establishes the above described rules for SEPA-payments, but it also establishes common rules under which the Member States shall permit non-banks to provide payment services and creates the new business model of Payment Institutions. The main feature of a payment institution is that the prescribed initial capital is much lower than the initial capital mandated for banks; in fact the initial capital requirement is Euro 20,000, Euro 50,000 or Euro 125,000, depending upon types of payment services rendered.

The Payment Service Directive finally also includes rules regarding the liability for an incorrect payment authorization and establishes extrajudicial complaint procedures as well as extrajudicial dispute settlement procedures.

The Payment Service Directive requires implementation by the Member States by amending the Member States national laws.

As regards a time line, the SEPA-project may be separated into three phases: design phase, implementation phase and migration phase. The design phase began in 2004 and the implementation phase in the middle of 2006. The last phase, the migration phase, began in early 2008. By the end of 2010 all SEPA instruments shall be operative and in general use.

What impact does SEPA have? SEPA does in fact offer advantages to all market participants. Consumers will only need one bank account. From this bank account, they will be able to effect credit transfers and direct debit throughout the Euro Area as easily as it is making national payments. For example, you could pay the rent for your children studying abroad, effecting payment to the landlord's account abroad, as if it were a national payment. The use of payment cards will be more efficient, since consumers will

be able to use one card for all Euro payments. This reduces the necessity to carry cash in one's pocket.

For merchants it has the advantage that customers will increasingly make use of payment cards which will replace, in the long run, cheques and cash payments. This is advantageous in so far as the clearing of card payments is much more inexpensive than clearing cheques or cash payments.

Companies have the advantage that they will be able to perform their entire Euro denominated transactions centrally from one bank account using SEPA-payment instruments.

To continue the development of the Single Euro Payment Area, the European Union has passed Regulation 3656/2009 on Cross-Border-Payments, which replaced Regulation 2560/2001 on Cross-Border-Payments in July 2009. The decisive change in this new regulation is that it does not only regulate that cross border payments shall be equal to national payments, but also that it establishes an interchange fee for cross border direct debit transactions. It sets a multilateral interchange fee of maximum €0,088 per transaction, to be paid to the payment service provider of the payee.

## **GUARANTEES AND CURRENCY FLUCTUATION ISSUES\*\*\*\***

### **1. Guarantees**

#### **1.1 Introduction**

The section of the paper outlines the nature of guarantees under Australian law. A guarantee is, in basic terms, an obligation to be responsible for the debt of another or to ensure another does not default on its obligations.

The nature of guarantees under Australian law can conveniently be divided into two groups:

- (i) guarantees granted by real persons, or
- (ii) guarantees granted by companies.

While the law relating to personal and corporate guarantees will frequently overlap, the characteristics of both the personal guarantor and corporate guarantor warrant their respective treatment.

Specifically, the law provides individuals with special protection when granting guarantees because they may be vulnerable to exploitation for a variety of reasons.

On the other hand, companies are often assumed to be sophisticated entities and exploitation will be less of an issue. For companies, the risk is that directors may not be acting in the company's best interests, and this may provide reason to question any guarantee that they grant in the company's name. Additionally, if a company is insolvent, or near insolvency, a guarantee may be avoided if the interests of the guarantor's creditors are not considered.

Performance bonds, or bank guarantees, are a similar obligation. However, they can be distinguished from guarantees. Unlike guarantees, performance bonds are fully independent of any underlying obligation and will operate without many of the protections offered in the case of guarantees. The characteristics of performance bonds under Australian law are also considered below.



## 2. Personal Guarantees

### 2.1 Introduction

If an individual offers a guarantee under a payment mechanism, Australian law provides a variety of means to ensure that the individual is protected and their vulnerabilities can not be exploited. The forms of protection offered in Australia are the following:

- (i) the doctrine of unconscionability;
- (ii) the doctrine of undue influence; and
- (iii) consumer credit codes that have force under statute.

### 2.2 Unconscionability

The notion of unconscionability exists as a principle of equity, a body of law initially developed by the Court of Chancery in England. While administrative distinctions between common law and equity have effectively been removed in Australia, principles of equity continue to develop independently from the common law. Under certain circumstances, equity will override common law rules, particularly where these rules operate unfairly upon a certain party.<sup>11</sup>

It is in this context that the notion of unconscionability can relieve a guarantor of their obligations where that guarantor is a person. In *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447, Mason J of the Australian High Court identified such situations as when:

a party makes unconscientious use of his superior position or bargaining power to the detriment of a party who suffers from some special disability or is placed in some special situation of disadvantage.

While Judges have been reluctant to restrict the circumstances in which the doctrine identifies disability or special disadvantage, likely scenarios include the following:

- (i) where a party is adversely affected by: poverty; age; sickness; drunkenness; illiteracy; language; or lack of education; or
- (ii) where a party has disadvantage arising from physical or emotional dependence.

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<sup>11</sup> Halsbury's Laws of Australia [185-1] – [185-10]  
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Unconscionability has additionally been found where there has been exploitation of the relationship of trust between husband and wife. A bank's enforcement of a guarantee in *National Australia Bank v Garcia* (1998) 194 CLR 395, was deemed unconscionable in this regard, and the wife guarantor was relieved of her obligations.

Inequality of bargaining power has usually not been seen on its own as a special disability or disadvantage,<sup>12</sup> however inequality of bargaining may be a key factor in determining whether the action of the superior party has been unconscientious.<sup>13</sup> Other factors, such as an insufficiency of consideration, while unnecessary to show unconscionability, may additionally influence such a finding.

### 2.3 Undue Influence

Undue influence is a related, although distinct concept to unconscionability that can operate similarly to relieve a guarantor of their obligations. While the two doctrines are not mutually exclusive, they need to be distinguished.

In the case of undue influence, the relationship between debtor and guarantor is examined, while in the case of unconscionability, it is the actions of the creditor that are critical. Under Australian law, undue influence of a guarantor may result in the actions of the creditor being unconscionable, although experience suggests, that it will be the actions of the creditor that are the focus of attention. For this reason undue influence has played a smaller role in protecting guarantors.

By contrast, in the UK, undue influence has been the focus of actions to protect guarantors. The general experience of the courts has been to examine whether the creditor had constructive notice of any undue influence between debtor and guarantor, and use this as a basis to relieve a guarantor's obligations. *Royal Bank of Scotland v Etridge (No 2)*[2001] 4 All ER 449 is typical of this approach and is another example of the law protecting guarantor spouses.

It appears that while the approach of both countries in using the law of equity to provide relief to guarantors has been slightly different, in practice, the results are largely the same.

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<sup>12</sup> *ACCC v Berbatis* (2003) 214 CLR 51

<sup>13</sup> See generally Halsbury's Laws of Australia [110-5905] – [110-5925]  
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## 2.4 Statutory Protections

In Australia, the Uniform Consumer Credit Code operates to regulate finance given to individuals for personal or household purposes. It strictly regulates the way in which finance is provided to individuals, including mandating the form of documents, restricting marketing and otherwise controlling the way in which individual borrowers and guarantors are dealt with.

Particular financial transactions are exempted from the Code, however where the Code applies, it provides significant rights to guarantors, including forms of contract review. It is expected that later this year, the Code will be replaced by a National Consumer Credit Protection Act. At the time of writing, the Act is awaiting passage through Australia's federal parliament. Once fully implemented, the Act will further strengthen rights to all credit consumers, including those who provide guarantees.

In practice, consumer legislation provides significant protection to individual guarantors, although the scope of transactions and individuals who are covered is not universal.

## 3. Corporate Guarantees

### 3.1 Corporate Benefit

Directors of Australian companies have both a statutory and common law duty to act in good faith in the best interests of the company and for a proper purpose<sup>14</sup>. In order for directors to comply with these duties, it is sometimes said that there is a need for corporate benefit when they grant guarantees or perform other acts on behalf of the company.

While companies will often operate in large corporate groups that in effect are single economic units, corporate benefit needs to be shown for the individual company, not merely the group as a whole<sup>15</sup>. Where a company is a wholly owned subsidiary, the law acknowledges that a director can act in the best interests of its holding company where certain conditions are met.<sup>16</sup> In these

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<sup>14</sup> *Corporations Act 2000 (Cth)* Section 181

<sup>15</sup> *Walker v Wimborne* [1976] 137 CLR 1

<sup>16</sup> *Corporations Act 2000 (Cth)* Section 187  
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situations, if a subsidiary offers a guarantee, corporate benefit will most likely be obvious.

However if a guarantee is offered by one company to another company within a group, further details of their relationship may be required to determine what benefit the guarantor gains from the transaction. Generally, Australian courts have given wide scope to directors to look at indirect benefits of membership of a corporate group, including the reputation or insolvency of another member of the group and the reliance of one company on others in the group for funding or management<sup>17</sup>.

If however, directors of a company are not able to conclude that the granting of a guarantee provides corporate benefit, fully informed shareholders, can ratify the transaction. Shareholder ratification may not be sufficient however if a company is insolvent, or near insolvency, in which case the interests of creditors become relevant to any decision of a company<sup>18</sup>.

Recent litigation in Australia has tested the limits of what may constitute corporate benefit. The Bell Group decision,<sup>19</sup> was one of the largest pieces of litigation in Australian history. In October last year, The Western Australian Supreme Court handed down a 2643 page, 1,084,735-word judgment, in which a refinancing arrangement for the Bell Group was set aside for, amongst other reasons, insufficient corporate benefit to the guarantors of the agreement.

The refinancing was intended to: 'keep alive' companies within the group. However, without an ongoing plan to maintain continued operation of the companies, this was held to be insufficient to constitute corporate benefit.

When applying the facts, the court was onerous in its requirements on directors. Because the companies were at or near insolvency, the directors of each company had to consider the interests of its creditors, however the court found that this entailed a requirement to consider the position of each creditor individually. This seemed to go beyond what was the accepted law in Australia.

The decision also focused on the role that the lawyers played in the transaction. The court placed great significance on the fact that the lenders' lawyers had been

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<sup>17</sup> See for example, *David Murray Holdings v Reid Murray* [1972] 5 SASR 386, *Equiticorp Finance Ltd v Bank of New Zealand* [1993] 11 ACSR 642

<sup>18</sup> *Kinsela & anor v Russell Kinsela Pty Ltd* (1986) NSWLR 722

<sup>19</sup> *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* (2008) 225 FLR 1 ; (2008) 70 ACSR 1 12684479.8

closely involved in the drafting of the minutes for each guaranteeing company, and that the minutes for each company were identical.

In summary, the Bell group decision is a good example of how Australian law ensures that where companies provide guarantees to related entities of a corporate group, the motives and actions of the directors of the company will be carefully examined. This is to ensure that the guarantee will provide benefit to the individual company and not just a corporate group as a whole.

### **3.2 Approaches Outside Australia**

Both US and European approaches to corporate guarantees operate in a somewhat different way. In the United States, the notion of Fraudulent Conveyance enables guarantees to be avoided, or the amount recoverable to be reduced. Typically, the avoidance of guarantees is seen only in bankruptcies, but a fraudulently conveyed guarantee may be avoided or limited absent bankruptcy.

Fraudulent Conveyance occurs when either the guarantor is insolvent at the time of the guarantee or, the guarantee would leave it with insufficient capital to carry on its business and there is insufficient benefit for the granting of the guarantee.

Examining the potential effect of a guarantee on the assets of a company, is an approach that is repeated under maintenance of capital rules that operate in parts of Continental Europe. One consequence of the US and European approach is that guarantees may be limited to an amount that is a percentage of the company's assets.

Since Australian law in relation to corporate guarantees does not directly focus on the capital maintenance of the guarantor, it can be distinguished from these other approaches.

## **4. Other Guarantee Situations**

### **4.1 Performance Bonds**

A performance bond, or bank guarantee, is a guarantee given by a bank to support the performance or credit of one of its customers to third parties. Although titled guarantees, virtually none of the rules that have already been

stated will apply to these agreements. In this regard, performance bonds are similar to Letters of Credit. Performance bonds are primary obligations and are fully independent of any underlying contract. Often, demands may be made without reference to any underlying contract at all<sup>20</sup>.

This status of performance bonds was recently challenged in the Australian Federal Court case of *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd* [2007] FCA 881. At first instance, an injunction preventing the exercise of the performance bond was granted on the basis that the party calling on the performance bond was acting in an unconscionable manner. It was held that calling on the performance bond was inappropriate given the positions of the parties in relation to their performance of the underlying contract for the construction of an offshore oil and gas field.

This decision was the subject of an appeal to Australia's Full Federal Court<sup>21</sup>. The appellate court reversed the position and overturned the injunction. The court found that there was very little, if any, scope for the application of equitable doctrines of unconscionable conduct to restrain the exercise by a party of its legal rights under agreements of the nature of performance bonds. The court considered the commercial purpose of performance bonds and considered that in the absence of fraud there was little room to prevent the enforcement of what is agreed between the parties.

In summary, performance bonds represent a means under Australian law for contracting commercial parties to have certainty in an agreement to honour performance. As opposed to other forms of guarantee, notions of unconscionability, despite recent challenges, will generally not be applicable.

## **5. Currency Fluctuation Issues**

### **5.1 Foreign Currency Markets and Risk**

Because an overwhelming majority of countries have a floating exchange rate, currency fluctuation entails a significant risk in international transactions for individuals, institutional investors, financial institutions, governments and multi-national corporations.

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<sup>20</sup> *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443

<sup>21</sup> *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd* (2008) 249 ALR 458  
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Foreign currencies are traded on markets across the globe every moment of every business day. Participants in these markets include banks, foreign exchange dealers, individuals, firms, speculators and treasuries, who all trade for different reasons. The types of payment mechanisms that are appropriate for international transactions fundamentally relate to risk management and entail various ways to absorb, negotiate and minimize exposure to risk of currency fluctuation.

**Currency exposure** or risk is a measure of the potential for a party's costs or revenues or the value of its assets or obligations to change because of a change in exchange rates. One example of currency exposure is **transaction exposure**, being the risk of changes in the value of outstanding financial obligations after the obligations have been entered into, due to changes in exchange rates. Transaction exposure most frequently arises when a party has a receivable or payable loan due that was denominated or invoiced in a foreign currency. In this sense, the potential for gains or losses on foreign currency obligations when those obligations are paid may constitute considerable transaction exposure or risk.

Being regarded as the most dominant currency, historically, commodities are most often traded in USD, often referred to as a 'surrogate' world currency. Trading in USD can eliminate exchange risk to some degree. However non-commodities (such as various kinds of equipment) are most often traded in the local currency of the vendor. Because goods may be paid for in installments over a number of months or years, parties can contract with financial intermediaries who absorb the exposure or risk for a fee.

There are a number of possible options companies, individuals or other parties to transactions can take to reduce their exposure to risk of currency fluctuation. In addition to the **spot market** (the rate of exchange at a particular point in time) there are many **derivative markets** based on the underlying value of the spot market. There are markets for currency forwards and futures, currency swaps and currency options. The derivative markets are used for speculation (a position is taken in expectation of a profit) or they are used in hedging (they can reduce the risks associated with paying or receiving foreign currency cash flows).

## 5.2 Hedging

Many parties attempt to manage their currency exposures through **hedging**, a term coined from the expression 'to hedge your bets'. In its simplest form, hedging is to take a position that limits the exposure of the original obligation, either by entering into a contract that will offset the risk of the original obligation or by locking in an exchange rate in advance of when payment is due. While

hedging can protect a party from a loss, it also eliminates the chance of any gain resulting from a favorable currency change.

Parties to a transaction can manage their currency exposure by engaging in **contractual, operational** and **financial** hedges. Contractual hedges employ the forward and futures market, money market, and the options market, while operating and financial hedges employ the use of natural hedging, risk-sharing agreements, leads, lags and swaps.<sup>22</sup>

### 5.3 Contractual Hedging

An example of use of **contractual** hedges is given below:<sup>23</sup>

An Australian company sells heavy mining equipment to customers around the world. It expects to receive USD 1M from an invoiced sale in three months. This transaction exposure can be managed in four ways:

- The company can choose **not to hedge** which means the proceeds from the sale may be worth more or less than the current rate when the money is received and converted at whatever rate is prevailing in the spot market at the time.
- The company can agree to **sell forward** USD 1M in three months at the current forward rate. This will lock in the amount receivable in Australian dollars at the rate currently available in the forward market.<sup>24</sup>
- The company could take out a **money market hedge**. It could borrow \$US 1M from an investment bank and convert it to Australian dollars at the current spot rate. By exchanging at the current rate it attains certainty of the exchange rate as well as acquiring its payment early. When the USD 1M is received from the customer it can repay the loan directly in USD 1M. The cost of offsetting the risk is the interest on the loan paid to the bank.<sup>25</sup>
- The company could buy an **option** to sell \$US 1M in three months at the current rate. This eliminates the downside risk as the option would be exercised if the exchange rate moved against the company. The upside

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<sup>22</sup> D K Eitman, A I Stonehill and M H Moffett, *Multinational Business Finance*, 11<sup>th</sup> Edition, Pearson Addison Wesley, Sydney, 2007, 260.

<sup>23</sup> This example is based on a larger complex case study involving US and British firms given in *Multinational Business Finance*, above n1 at 260 – 271.

<sup>24</sup> Further notes on futures and forwards are found below.

<sup>25</sup> The customer (buyer) in this transaction could also take out a money market hedge by contracting with a bank to buy \$US 1M in three months time at the exchange rate currently available on the spot market. This eliminates the risk for the buyer, and ensures certainty of the rate, although the buyer must also forfeit any potential benefits they may have received on a favourable exchange rate in three months time. This is referred to as a 'lock in rate', and the buyer pays a percentage fee for the bank lender absorbing that risk.



potential of the exchange rate movement would still be available as the option could be left to expire if the exchange rate moved in favor of the company. The cost of this hedge would be the premium paid for the option.

- A currency option is a 'contract giving the option purchaser (the buyer) the right, but not the obligation, to buy or sell a given amount of foreign exchange at a fixed price per unit for a specified time period (until the maturity date).'<sup>26</sup> There are two types of options:
  - A call is an option to buy foreign currency.
  - A put is an option to sell foreign currency.
- Every option has three elements:
  - the exercise or strike price (the exchange rate at which the currency can be purchased (call) or sold (put));
  - the premium (the cost, price of value of the option itself); and
  - the underlying or actual spot exchange rate.<sup>27</sup>
- Options can be bought on the over the counter (OTC) market and then tailored to the specific needs of the party or they can be bought on organized exchanges in standardized form.

#### 5.4 Futures and Forwards

Futures and forwards are examples of trading a currency forward, with different benefits or advantages to businesses depending on their individual requirements. Generally, futures are comprised of a range of standard products that can be purchased on the futures exchange and are usually closed out (or sold on), while a forward is an over-the-counter (OTC) transaction between a company and a bank that can include particularised terms appropriate to the transaction.

- **Futures**

The main market for currency futures in the United States is the International Monetary Market (IMM), which is a division of the Chicago Mercantile Exchange.<sup>28</sup> Individuals or companies can buy currency futures through a futures exchange or broker. A currency futures contract calls for future delivery of foreign currency from a range of pre-determined amounts (for example, \$1,000, \$5,000 or \$10,000) at a fixed time, place and price. For example, one might buy a future to deliver USD 1,000 at a rate of AUD 1,200 per USD 1,000 in three months time. Unlike forwards, the terms and rates are standardized. Maturities (the expiry date or when a party needs to deliver) are typically less than one year and are traded on

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<sup>26</sup> *Multinational Business Finance*, above n1 at 211.

<sup>27</sup> *Multinational Business Finance*, above n1 at 212.

<sup>28</sup> *Multinational Business Finance*, above n1 at 208.

exchanges so that futures are rarely delivered upon or settled. Instead, like shares, the positions are 'closed out' (sold): another opposite future is purchased and the customer only receives the net difference in value from the broker.

Futures have an initial margin that is **marked to market** on a daily basis. For example, the forward rate of AUD 1.20 to USD 1 will be different to the spot market rate of (for example) AUD 1 to USD 1 because it reflects an anticipated or speculated change in exchange rates. The difference in value is called a margin and acts as security for the broker. If the value of the future on the exchange falls beyond a certain level the broker will make a margin call and ask for extra payment to maintain the margin. This 'maintenance of margin fee' is 'marked to market' (ascertained in relation to current and expected market rates).

- **Forwards**

Many companies chose to use forwards instead of futures for hedging because futures are often too standardized for companies to allow for complete cover of an exposure, and because margin calls may be a nuisance in the day to day management of cash flows. Forwards are an OTC product where a party can go the bank and purchase a certain amount at a certain exchange rate that is tailored to their own business needs. Forwards are more common in use by companies. They have the advantage of being individually tailored to a company, involve a lock-in position, and require a relationship with a bank instead of relying in margins. Forwards are used mainly for hedging as physical delivery of the currency is required.

## 5.5 Operational and Financial Hedging

**Operational** and **financial** hedges are commonly employed to manage long term or recurring currency exposure in the operation of business. They involve taking proactive measures including:<sup>29</sup>

- **Natural hedging:** Natural hedging is the matching of currency flows and involves the creation of foreign currency outflows to match equivalent foreign currency inflows. This can be done in a number of ways, for example, ensuring suppliers are sourced from the same country as the customers. An Australian company

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<sup>29</sup> These examples are derived from and discussed in much greater detail in *Multinational Business Finance*, above n1 at 312 – 319.  
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selling televisions in Canada may ensure its suppliers are Canadian, its service fees are paid in Canadian dollars, or that it otherwise incurs debts in Canadian dollars so that the company's costs match the currency in which its cash flows are received. Another way to match currency flows is to switch the currency of invoice if this is economically possible.

- **Risk sharing agreements:** Where the risk is too great for the vendor or purchaser, the parties may make enter into a risk-sharing agreement. These can include sales and purchasing contracts between parties operating in different currency areas including clauses that any gain or loss caused by a change in the exchange rate will be shared by the two parties. Often these contracts take the form that the risk will be borne by one party alone unless the exchange rate moves outside a particular range and then the amount paid will be adjusted to share the risk. For example, if the currency fluctuates over 5% of the spot market rate at the date of purchase, any difference between the invoice price and the actual price may be halved between the parties.
- **Leads and lags:** Leads and lags refer to the length of payment terms in a transaction and can be written into payment terms to suit the parties. A purchaser may choose to tailor its payment terms according to the potential for currency fluctuation. Countries with particularly fluctuating currencies (such as Mexico or Brazil) are often referred to as 'soft' currencies, whereas countries with generally stable currencies are referred to as 'hard' currencies. Where it is economically possible, a purchaser may desire a 'lead' or early payment time frame (for example, within 7 days) for dangerous or fluctuating currencies, while they may chose a 'lag' or late payment period for hard or stable currencies (for example, 90 days).
- **Back-to-back loans:** Back-to-back loans are a rare form of risk management occurring where two companies have subsidiaries in each other's country. Each company may agree to lend their home currency to each other through the subsidiary and agree to pay each other the same amount at a later date.
- **Currency swaps:** Currency swaps are a popular form of operational or financial hedging. In an ordinary currency swap, a party and a bank may agree to exchange an equivalent amount of two different currencies for a specified period of time to eliminate currency risk. For example, a Japanese company may be exporting goods to the US and earning USD in the process. It may have borrowed money in its home market in Yen where it is well known and has secured good terms. The company may buy a swap from an investment bank where it agrees to pay a certain amount of USD per month in return for the equivalent in Yen to pay its interest at the Japanese bank. The investment bank

then absorbs the risk of fluctuation and the company pays a fee in exchange for the certainty of a fixed rate.

- Currency swaps such as these can also be combined with interest rate swaps, so parties can eliminate both their currency risk and interest rate risk simultaneously. In addition to swapping cash flow (a nominated principal), they may choose to also swap from, for example, a floating to a fixed interest rate. For example, a party may have a loan of USD 1M from a bank at a floating interest rate, which it may choose to swap for a loan in AUD at a fixed interest rate. In this manner (and for a fee) the party swaps both the nominated principal loan amount and the interest rate to reduce exposure on both currency and interest fronts.<sup>30</sup>

## 5.6 Summary

There are a number of ways for parties to transactions to manage their exposure to risk in currency fluctuations. Having financial intermediaries absorb risk can ensure certainty of exchange rate in return for incurring a cost, whether through interest rates (in the money market), premiums (when purchasing options), and the difference between the current exchange rate and the forward exchange rate (when purchasing futures and forwards). Outside of options there is another cost. The certainty of exchange rate comes at the price of relinquishing the upside of a favourable foreign exchange movement. While contractual hedging is best suited to large, one-off transactions such as large loans or purchases of large equipment from which currency fluctuations could make a significant impact upon profitability, operational and financial hedging (such as natural hedging) is suited to cover long-term recurring exposure relating to the basic operation of business.

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<sup>30</sup> Further information on currency swaps and interest rate swaps can be found in *Multinational Business Finance*, above n1 at 474 - 482.  
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## INSOLVENCY ISSUES\*\*\*\*

Insolvency or bankruptcy is used here as a term to signify a court supervised process, through which all creditors seek to find full or partial fulfillment of debts by jointly making use of the debtor's assets. This may be achieved not only through liquidation, but also through reorganization. Along this line, most bankruptcy laws are divided, favoring either concept, and the issue of rescission of last-minute payments is often judged accordingly.

Payment mechanisms need to ascertain that the creditor will not only receive his payment, but rather, that he may keep it. Therefore, a brief examination of payment in and prior to insolvency is required.

At least for the European Union, the ECJ in the judgement Frick/Euro Marty, ECJ 12.2.2009, C 339/07, has clarified that insolvency rescissions have to be brought in the courts of the jurisdiction, where the insolvency proceedings was commenced and follow the rules of these proceedings. Therefore, in this case of a payment by a German company to a Belgian company for goods delivered, the German courts, under the application of German law, were competent for the action of the receiver/trustee to regain the money. Therefore, in any international transaction involving payments, at least within the European Union, the payee will need to ascertain the situation in the jurisdiction of the recipient of the payment.

German law allows a recall of prior payments in case of insolvency for up to 10 years. This 10 year rescission period allows the recall of payments made up to 10 years prior to the commencement of the insolvency proceedings. The requirements for this rescission seem high: an intentional action, detrimental to the assets of the bankrupt person, with the knowledge of the recipient. However, in practice, this requirement is easily fulfilled: an action already is considered detrimental, if it only leads to reduced assets. Payment to only some creditors just as granting additional security, or other similar acts, are considered to be detrimental and thus would suffice. As to intent, it suffices if the debtor knows that his actions lead to a preferential treatment of some debtors. As to the creditor, if he is aware of circumstances that are in keeping with a possible insolvency (repeated late payments, requests for extensions), this may already be judged to signify knowledge on the part of the creditor of the debtor's intent to act detrimentally towards others, if the creditor receives payment.

Other rights to rescind prior payments or grants of additional securities (guarantees, pledges, assignments, mortgages and other such instruments) exist, with time periods

usually at the three and one month window prior to insolvency, or 4 years for all non-remunerative performance.

Regardless of the individual regulations under German law, the common underlying strategy is to allow the receiver to recall such outflows from the assets of the debtor, which are not set-off with corresponding, proportionate inflows, allowing the receiver to regain assets for the court-supervised process.

It is therefore of high importance to factor in such risks in designing payment structures. Especially with rescission rights, the creditor may falsely be of the opinion to have received payment, thus continuing performance, to find himself having to repay what he received, and being reduced to a mere insolvency claim for his performance.

In all payment situations, if there is only slight doubt as to the financial soundness of the other party, the rescission has to be taken into consideration. One possible solution in such situations is to cut losses, by entering into a new contract, with a strict quid-pro-quo payment structure, which at least under German law, will do away with any risk of recall.