

Basics of Trade Finance – A Legal Perspective

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USING TRADE FINANCE IN YOUR BUSINESS

From the financial perspective, two issues will typically be on your mind when you enter into a trade transaction with a foreign firm: (1) how will you secure payment; and (2) how will you free up cash or secure financing to continue funding your penetration of the international marketplace. Trade finance directly addresses both of these issues.

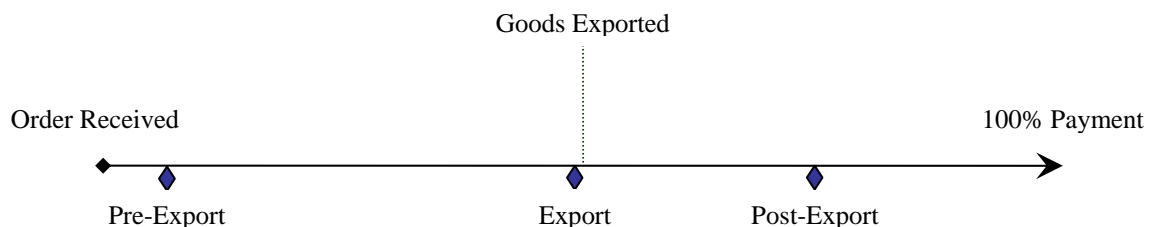
At a fundamental level, trade finance is a tool that you can use to reduce your risk of non-payment or late-payment and increase your rewards by putting you in the position to capitalize on opportunities to sell your goods. Here are some of the basic “tools” of trade finance:

- Bills of lading
- Bills of exchange
- Documentary letters of credit
- Standby letters of credit
- Independent Guarantees
- Insurance
- Financial leases
- Promissory notes
- Assignments
- Security agreements

The above “tools” are used in various combinations to provide for payment or as a means of protecting against non-payment by a counterparty. Bills of exchange and letters of credit are forms of payment that, in the past, have been the dominant solution to transferring payment over tremendous distances. As international commerce and finance become more complex, trade finance professionals are turning to secured transactions and structured finance to better align payment and risk.

WHEN YOU SHOULD CONSIDER TRADE FINANCE

Trade finance can be an excellent way to shift your risk to a third-party and free up cash. If you imagine a timeline of your transaction, trade finance can come into play at three points – before the goods are exported (pre-export); at the time the goods are exported; and after the goods are exported (post-export).



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The below table shows how three scenarios might play out under pre-export, export and post-export conditions. Potential financing options are also included so that you have a better idea of possible results.

Timing	Scenario	Options	Results
Pre-export	You receive a large, capital-intensive order and do not have sufficient cash on hand to meet it. What are your options?	<ul style="list-style-type: none"> • Purchase order finance • Possibly assign accounts receivable 	You receive approximately 80% of the value of the p/o or a/r and successfully close another sale.
Export	You are concerned that buyer will accept goods and not pay or pay late. What are your options?	<ul style="list-style-type: none"> • Letter of credit • Bill of lading • Insurance • Guarantee 	You require buyer to pay upon delivery, hedge any remaining risk and count your profits.
Post-export	To get the business, you agree to 60 days net but prefer payment as soon as possible. What are your options?	<ul style="list-style-type: none"> • Forfait • Factor • Assign accounts receivable • Assign letter of credit • Assign bill of exchange 	You immediately convert 80-100% (minus a fee) of your receivables to cash, and are in position to continue to grow your sales.

HOW THE LAW IMPACTS YOUR TRADE FINANCE TRANSACTION

Trade finance is an intersection of many rules that govern payment, finance and protection from default in the context of commercial transactions. To make it easy to contract business, the core rules are combined into codes of law that are easily accessible to all who are involved in business transactions. This is particularly important when conducting business in the global marketplace.

Example: In the U.S.A., most of the laws that directly govern trade finance transactions can be found in the Uniform Commercial Code (UCC). One or more of the following Articles of the UCC may apply to your trade finance transaction:

- Article 3. Commercial Paper
- Article 4. Bank Deposits and Collections
- Article 4A. Funds Transfers
- Article 5. Letters of Credit
- Article 7. Warehouse Receipts, Bills of Lading and Other Documents of Title
- Article 9. Secured Transactions

Visit our [International Trade Links](#) to learn more about the UCC.

From a legal point of view, trade finance transactions can be particularly challenging for a very simple reason: instead of dealing with one set of laws, you now have to deal with at least three sets of law – your country’s laws, your trading partner’s country’s laws and international rules or laws.

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Example: Here's a brief list of international rules or laws that may affect your trade finance transaction:

- The Uniform Customs and Practices for Documentary Credits (UCP 500)
- The Uniform Rules for Collections (URC)
- The UNIDROIT Convention on International Factoring
- The Ottawa Convention of 28 May 1988
- The Uniform Rules for Demand Guarantees
- UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit
- Article VIII(2)(b) of the Articles of Agreement of the IMF (currency exchange rule)

Visit our [International Trade Links](#) to learn more about the above-listed items.

Of course, familiar laws, such as contract law, also apply to trade finance transactions. These laws can be said to govern trade finance transactions from afar, which usually means that they are not noticed until something goes wrong. One story that I always keep in mind is particularly appropriate.

An English businessman, eager to grow his business and lacking the necessary finances, mortgaged the family house without fully explaining the particulars of the transaction to his wife. Business did not go so good and, as you can imagine, the bank eagerly began foreclosure proceedings. The wife was not happy about this turn of events and promptly sued the bank. She won! According to the Court, her agreement to the transaction had been obtained through "undue influence" and therefore the contract was voidable. Because the bank had failed to insist that the husband and wife each consult legal counsel, it was out of luck. (See *Barclays Bank v. Mrs. O'Brien*).

TRADE FINANCE: MANAGING YOUR RELATIONSHIP WITH THE COMMERCIAL BANK

In your initial contact with a provider of trade finance, whether it is a commercial bank or some other type of financier, there will be an assessment of the risks involved in your transaction. Besides a general indication of strong sales, a reasonably solid financial footing, sound management and possibly the credit-worthiness of other parties to the transaction, you may need to disclose business specifics. Once you have satisfied the potential financiers initial information request, they will make a decision about whether they will proceed. Generally, a decision can be obtained in a week or less.

If a decision is made to proceed, you will enter a period where the financier will seek to become very comfortable with your business, your short-term objectives and future plans. One or more site visits may be conducted with the goal of making sure that all is as you say it is. This is an important time in the building of the relationship and generating trust is key. Your goal should be to learn all you can about the financier and become comfortable with its culture, operations and its expectations of you and your business.

At some point in the transaction, densely worded legal documents will be provided to you and your signature will be required. Depending on your familiarity with the transaction, you may proceed to sign the agreements without the advice of legal counsel. If you are not comfortable, you will of course consult your legal counsel. Some business people ask questions of the financier or its lawyer, and are generally surprised when they receive little or no advice. Because they do have legal exposure (see the last paragraph of the above section), many financiers will strongly advise you to consult counsel and are careful to avoid providing you with information that can be interpreted as legal advice.

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Once the agreements are signed, funds are disbursed and you and the financier enter into the management part of the relationship. At this point, the focus is on collections and maintaining the quality of collateral. This period of the transaction may be brief or, in the case of a factoring relationship, ongoing.

USING EXPORT CREDIT AGENCIES (ECAs) TO EXTEND YOUR MARKET REACH

For exporters, export credit agencies (ECAs) are excellent sources of loans, guarantees and insurance. ECAs act both directly, through the extension of guarantees and the writing of insurance, and indirectly, by working through commercial banks to underwrite loans.

In his book, *Export Credit Agencies The Unsung Giants of International Trade and Finance*, Delio E. Gianturco defines an ECA as “(1) a highly specialized bank, insurance company, finance corporation, or dependency of the government, (2) offering loans and/or guarantees, insurance, technical assistance etc., to support exporters, (3) covering both commercial and political risks related to export sales, (4) with the backing or approval of the national government, and (5) dedicated to supporting the nation’s exports.”

ECAs specialize in managing risk and, through their knowledge and skill, enable you to export to countries that do not fit the risk profile of commercial banks or other types of financiers. Their ability to extend financing at competitive rates to developing countries may allow you to sell more products to more places.

Visit our [Export Credit Agency Links](#) page to find out whether an ECA or a development bank can enhance your ability to profitably export goods.

PROTECTING YOUR INTERESTS

The best way to protect your interests is to have a thorough grasp of the trade finance transaction, the various parties and the short and long-term impacts of the trade finance transaction on your business. Reading this short article and downloading our [Working Capital Finance Case Study](#), will expose you to some of the issues. Our [Trade Finance Links](#) page puts a wealth of information at your fingertips. We will work hard to continue to add useful information to this website, so be sure you add it to your web-browsers “Favorites” list.

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