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Legal Considerations in Cross-Border Cash Pooling

How the structure of a cash pool affects legal liability if one or more participants in the pool experiences financial distress.

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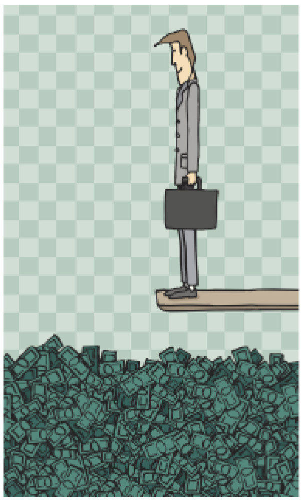
September 28, 2017 • Reprints



For treasurers of multinational corporations, cross-border cash pooling can be a vital tool for managing cash on a daily basis. And it makes a great deal of sense to have some members of a corporate group offer up their excess cash in order to meet the needs of the enterprise, from repayment of corporate debt to support of business units that need an influx of capital, to investment of aggregated cash balances for optimal returns. However, waters in the cash pool can turn murky when the enterprise is in distress.

Because legal structures and documentation differ between physical cash pools and notional cash pools, the effects of financial distress on an organization's cash flows depends on which of these structures defines the cash pool. The differences between a physical and a notional cash pool are significant.

In a physical cash pool, participants agree to move their excess cash on a periodic basis to an entity within the corporate group called the cash pool leader. The cash pool leader concentrates excess cash from participating business units and uses those funds for the benefit of the participants. Cash pool participants with a cash deficit can receive an intercompany loan from the cash pool leader and pay interest to the cash pool leader. Participants that contribute excess cash to the pool receive interest on the funds they make available. This structure enables a company to deploy cash to the best possible effect across the enterprise. Funds advanced to the cash pool leader appear as an asset on the balance sheet in the form of intercompany loans. Similarly, funds borrowed from the cash pool leader appear as a liability, classified as intercompany loans incurred.

In contrast, a notional cash pool involves no physical movement of funds. Instead, the company appoints a bank to maintain and monitor a consolidated, cross-border, enterprise cash position. The bank operates the notional "pool" so that participants with excess balances receive interest and participants with cash deficits receive interest-bearing loans from the bank to cover those deficits.

Corporate funds do not actually move in a notional pool; the bank advances funds to cash pool participants that experience a deficit of cash. This means the bank must receive guaranties of these obligations from all cash pool participants, as well as the right to offset investment balances held by any cash pool participant. The bank usually will not allow the aggregate of borrowed positions of cash pool participants to exceed the excess cash available globally within the corporate cash pool. Thus, the bank ensures its exposure is always covered by its offset rights in the credit balances; the offset right is the main mechanism for ensuring that the bank will recover all the funds it advances on any given day.

Insolvency Issues in Notional vs. Physical Cash Pools

The decision of whether to pool cash on a notional or physical basis turns on tax, accounting, cost, and regulatory factors. Often, these two forms exist side by side, with one bank offering and serving both methodologies.

In physical cash pooling, where funds travel each day to the cash pool leader, excess funds are held in the currency in which they're submitted by the cash pool participant. This can make a cross-border physical pool impractical in regions with several currencies. In contrast, notional cash pooling involves daily conversion of all cash to an agreed-upon base currency, in which all investment balances (for excess cash) and extensions of credit (for deficit cash) are denominated.

The legal standing of cash pool participants vis-à-vis one another and the bank also differs depending on the methodology used. In the case of physical pooling, the cash pool participant with excess cash is explicitly lending funds to the cash pool leader, and cash pool participants with cash deficits are incurring an intercompany obligation to repay funds to the cash pool leader. A bank administers the program but has no direct economic exposure. The intercompany debts appear in the books and on the balance sheet of each participant, and are customarily evidenced by written loan documents.

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These obligations within the corporate group would not necessarily reflect market terms and would not be negotiated. However, in the event of enterprisewide distress, or a problem with a specific cash pool participant, they would create mutual and enforceable legal obligations between the cash pool leader and each cash pool participant. The cash pool leader would be in privity of contract with each separate cash pool participant.

Unless it has executed a separate guaranty, contribution agreement, or indemnity agreement, or otherwise benefits from a special legal theory (such as disregard of corporate formalities, fraudulent transfer, or preference), a cash pool participant that is unpaid by an insolvent cash pool leader can look only to the cash pool leader for recovery. Likewise, if a business unit that has received funds from the cash pool becomes distressed, the cash pool leader may proceed only against the particular cash pool participant to which it has advanced those funds.

Notional cash pooling presents very different challenges in the event of insolvency. A notional cash pool involves a credit relationship between the bank and each cash pool participant—albeit a credit relationship that is supported and secured by other entities' excess cash balances—but it does not, by default, involve legal obligations among the different cash pool participants. In the event of financial distress, and in the absence of separate contracts or special legal theories, participants in a notional cash pool have no rights against any other cash pool participant, even if funds from solvent cash pool participants are used to pay the debts of cash-starved participants.

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Recall that under notional pooling, the bank has the right to offset excess cash balances against obligations owed to it by cash-starved participants in the same cash pool. The bank will do so upon insolvency or other default situation, leaving the solvent cash pool participant devoid of funds and with no contractual rights against any sister companies it indirectly funded.

Common practice calls for the cash pool participants to enter into a contribution and indemnity agreement at the inception of the notional cash pooling program. Such an agreement will provide that, to the extent that the bank asserts any right of offset or guaranty claim against one cash pool participant in respect of a default of a sister company, the cash pool participant may recover its losses against the defaulting sister company. When multiple cash pool participants contribute, each should be entitled to its proportionate share of the indemnification that exists in respect of the cash-poor cash pool participant. Usually the bank will insist that these claims are available for assertion only after the bank has been paid in full.

Though they're certainly appropriate, contribution and indemnity agreements are sometimes nowhere to be found when they're needed most. In most companies, credit managers work diligently to manage insolvency risk outside the enterprise but may not prioritize a potential future insolvency within the enterprise. It may be considered a remote possibility, or simply unimportant in an investment-grade multinational because it concerns only rights against affiliates.

Additionally, the bank running the notional cash pool will want to limit the right to enforce the contribution and indemnity agreement until all obligations to the bank have been indefeasibly satisfied in full. Claimants will therefore be required to stand by until the bank fully recovers. Also, the existence of an agreement specifying the right of one cash pool participant to indemnification from other cash pool participants could violate bank covenants against guaranties and investments. This means any agreement likely would need to be entered into with the knowledge and involvement of the bank that runs the notional cash pool.

Subrogation Rights in Cash Pool Defaults

A contribution and indemnity agreement is the clearest way for one cash pool participant to receive repayment for losses incurred due to the default of another cash pool participant. However, companies in this situation that do not have an agreement may be able to seek redress under various legal theories. Principal among these is the right of subrogation.

Subrogation enables one party that has paid the debt of another party to succeed to the rights of the satisfied creditor. In the United States, subrogation is an equitable remedy designed to prevent injustice, and it is not created by statute. Other countries, such as the Netherlands, have statutes that confer rights similar to subrogation. Subrogation often arises in the context of insurance and real estate.

There are few legal guides for the application of subrogation in the cash pooling context. Nevertheless, notional cash pooling may give rise to circumstances of unsatisfied cash deficiencies that can be remedied by subrogation. Legal tests vary by jurisdiction, but a common one recognizes five elements that should be present to support a subrogation claim:

1. payment must have been made to protect the claimant's interest,
2. the claimant must not be a mere volunteer,
3. the claimant must not be primarily liable for the debt,
4. the entire debt must be paid, and
5. subrogation must not work an injustice to others.

The term “claimant” here is the party seeking subrogation rights (known as a “subrogee” in legal parlance).

What is the legal outcome when applying this test to a typical notional cash pooling program? Concerning the first requirement—that the payment made by the claimant must protect its interests—all cash pools should be able to demonstrate a commonality of interest among participants. The whole purpose of the cash pool is for participants to make funds available to promote their common interests in access to both funding of cash needs and investment of excess cash. And a cash pool will necessarily meet the requirement that the claimant not be a volunteer because each participant is contractually bound to the arrangement.

The third requirement, that the claimant not be primarily liable for the debt, is more problematic. One possible defense against collection of the debt through a claim of subrogation might entail characterizing the cash pool program as the joint obligation of all cash pool participants, in the form of an advance of credit from one segment to another. The counterargument would likely hold that the obligations are mere guaranties—that the cash pool participant had to enter into a guaranty in favor of the bank or grant the bank offset rights with respect to the debts of another cash pool participant. Viewed in this way, the obligation would not be characterized as direct, and so it would not be excluded from subrogation on these grounds.

The fourth requirement, that the entire debt must be paid, may or may not be satisfied based on the facts and circumstances. Suppose, for example, that the bank failed to fully recover its claim due to a cash deficiency. This would be a rare outcome and would involve failure of the bank's systems. Were it to occur, however, the debt would not have been satisfied in full. What, then, would happen if multiple cash pool participants contributed to satisfy the debt? There is no reason why multiple contributors should defeat a subrogation claim, and in this instance, each cash pool participant would maintain rights in accordance with its share.

The fifth requirement, that the claim be free of injustice to third parties, would also be dependent on circumstances. One example might be a claimant that has no collateral security, yet pays a secured debt, thereby surpassing in priority other secured creditors. This type of argument should not prevail, however, because it does not increase—but merely shifts—the aggregate amount of secured recovery. This fifth requirement should instead be warranted by specific circumstances that may not be capable of objective description in advance.

Some jurisdictions apply a less formulaic approach to subrogation and merely require that a party which pays the debt of another must have the opportunity to be paid in full.

Varying legal elements surface when considering the choice of law and jurisdiction related to any subrogation claim. Because these claims arise by law or equity, there will be no governing contractual choice of law to look to. One might contend that the governing law of the cash pooling program should apply to subrogation claims. But that case competes with other possibilities, such as the law of organization or headquarters of either the claimant or defendant, and also the location of relevant bank accounts. There does not exist at this time any legal guiding principle—and this presents a major impediment to satisfactory and predictable recovery in the event of insolvency within the enterprise. For this reason, it advisable to ensure that a contribution and indemnity agreement includes (among other things) the selection of applicable law and venue for hearing any disputes.

In a distressed enterprise situation, the rights of cash pool participants against one another also becomes highly relevant under some local corporate laws and other laws. These issues raise generally the question of corporate benefit. A starting point in most jurisdictions revolves around the specific findings of the board of directors (and, in some jurisdictions, the shareholders) that the program confers corporate benefit. This should be made explicit in the relevant resolutions and minutes of meetings. This benefit is easy to see when things are going well—the cash pool participant will experience assurances of liquidity and capital at a competitive cost.

A different state of affairs exists in insolvency and must be addressed jurisdiction by jurisdiction. Some of these will require advance planning. Germany, for example, requires a cash pool to give participants the right to refuse to fund if either recovery is in doubt or doing so would deprive the participant of essential liquidity. A properly operating cash pool should not deprive liquidity, but making advances (whether physical or notional) could very well trigger this legal constraint in the case of an insolvent enterprise.

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Several other jurisdictions require corporate benefit, which must be assessed over time and at the time of each draw on the cash pool, not merely at the inception of the transaction. Others require arm's-length terms, which may be difficult to either discern or, worse, may be deemed unavailable under the theory that loans to an insolvent entity simply should not be made. Violations of these strictures arrive in a variety of forms. If not properly managed, director and officer liability—both criminal and civil—certainly exist.

Anticipating action steps in the event of insolvency requires close consultation with counsel in each jurisdiction, with the bank overseeing the cash pool, and potentially with other parties such as auditors, treasury, tax, and corporate communications experts. Collaboration among these parties is critical to improving outcomes in trying circumstances.

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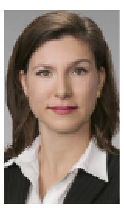

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