

ZARA
LAW OFFICES

***MANAGING THE RISKS OF CONDUCTING
BUSINESS WITH SMALL AND MIDSIZED
ENTREPRISES IN THE UNITED STATES***



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In the United States, small to medium sized companies or “SMEs” are defined as those employing less than 500 persons. The statistics show that 99.7% of the US firms fall into this category. Therefore, if you intend to conduct business in the US, you will most likely at some point be doing business with an SME. For these reasons, before starting exporting to, or doing business in the US, it is important you understand the risks foreign companies face when contracting with US SMEs, and the measures you should absolutely take in order to reduce such risks. This article is aimed at helping you, as a foreign exporter or buyer, to manage the risks inherent in international trade; in particular the risks you might be confronted with when selling to or purchasing from US-based SMEs, and to help you protect your interests accordingly.

D) IDENTIFY YOUR COUNTERPARTY

1. Who do you intend to deal with?

Typically, SMEs tend to be unlisted, i.e. privately held companies. In comparison to the restrictions applicable to listed or public companies, the regulations applicable to SMEs are far less restrictive, especially with respect to disclosure of information to the public. In fact, unlike in many European countries, there is no public database providing information on US SMEs. Thus, it is often very difficult, especially from overseas, to identify, the shareholders, managers or officers of a SME and to determine its legal status and financial condition.

For this reason, before starting any activity with a US SME, you need to gather comprehensive information about it. The following is a list of some of the relevant information it will be helpful for you to obtain:

- What type of entity is it? When was it incorporated ? Where is its principal place of business located?
- What is the entity’s credit history? What is its reputation on the market?
- For how long has the entity been in business? How many persons does it employ?
- What are its sales figures? Does it make any profits? Who are its most important clients and suppliers?
- Did the entity’s managers or officers previously set up another entity that is now defunct and which did not pay its debts?
- Has the entity ever been sued? If so, by whom? When? On which grounds? Was the entity found liable, and if so did it satisfy the Judgment against it?

There are a number of commercial websites where you can, for a small fee, retrieve some but not all of this information (e.g. www.knowx.com).

2. The absence of minimum capital requirements

Laws in the US pertaining to SMEs, exclusive of banks, insurance companies, and certain other financial entities, typically do not set requirements for minimum capital. This means that even a person with limited resources and/or poor credit history can create an

entity in the US. In general, it is easier to create an entity in the US than to create one in most countries in Europe where statutory requirements tend to be more restrictive.

Theoretically, US SMEs are supposed to commence operations with a an adequate amount of start-up capital¹ in order for their principals' not to be held responsible for the company's debts. However, you should know that it is rather difficult in the US to hold directors and shareholders personally liable for the company's debts (the legal concept of holding shareholders and directors personally liable is sometimes referred to as "piercing the corporate veil").

In order to determine if the managers and officers of a company ought to be held personally liable for its debts, courts take various factors and circumstances into account. Courts will assess any alleged undercapitalization; determine whether or not the company's directors and shareholders used the corporate assets for improper and/or unauthorized personal purposes such as unreasonably high salaries and/or benefits; and last but not least, whether they maintained good corporate records. These are the main elements that a court analyzes when it has to decide whether or not to pierce the corporate veil. If the only issue is undercapitalization, a court will not automatically pierce the corporate veil and thus will not automatically hold the directors and officers personally liable for the company's debts.

3) SME's have no obligation to operate from an office

In general, members of an SME are not, except in certain industries such as wine, required to maintain an office. Moreover, Internet and new technologies enable small companies to present themselves as much larger than they really are. For example, when you telephone a company you may be transferred to different departments. You may be under the impression that you are dealing with a relatively large company -however, the company may actually be run from a personal residence- and your correspondent may be utilizing different telephone lines and extensions to create that false impression.

Therefore, in order to avoid bad surprises you need to gather as much information as you can about the company you intend to do business with.

4) The absence of specific statutes applicable to SMEs

The lack of legal requirement and the absence of specific laws applicable to SMEs make the trade with US SMEs riskier than the trade with other US entities. In particular, it specifically increases your payment risks.

In order to mitigate such payment risks and to protect your interests, you as a seller must before starting any operation with an SME in the US, find out as much as you can about your US SME counterpart. And also you must have a well drafted sales agreement prepared.

¹ The amount of start-up capital that is adequate is sui-generis. In other words, it depends upon the circumstances: What is reasonable for one SME may be deemed totally insufficient for another involved in a completely different industry and/or with a completely different business model.

II) THE PROTECTIONS OFFERED BY U.S. LAW – HOW CAN YOU PROTECT YOURSELF AGAINST BUYER’S RISK OF NON-PAYMENT?



1. Personal or Third Party Guarantees

Owners, managers or officers of SMEs, as well as parent companies, or even non related companies may provide you with personal/third-party guarantees protecting you against the company’s failure to pay.

➤ Guaranty of Payment

The guarantor is primarily liable for the debt. In such case, you may request the payment from the guarantor even without first suing the buyer.

➤ Guaranty of Collection

The guarantor is secondarily liable for the debt. You may request the payment from the guarantor only after failing to collect the debt from the buyer.

2. Security Agreements

By entering into a security agreement with the buyer, the latter agrees to provide you with a security interest on its assets, including on the goods you shipped, and/or on receivables from third parties. Subject to a registration of your security interest in the applicable county clerk’s office, in the event buyer fails to pay you or files for bankruptcy, you will benefit from a priority over unsecured creditors. In other words, you will have the right to be paid before them in case of debtor’s bankruptcy, or in case of an assignment for the benefit of creditors² (subject to your security agreement).

² Certain States such as New York and Massachusetts have laws enabling debtors, as an alternative to Bankruptcy, to appoint a Trustee whose job is to collect the debtor’s receivables, sell its assets and distribute the proceeds in accordance with the order of priority.

Important considerations:

- You have to figure out if a third person has a prior security interest over those assets of debtor in which you may be given a security interest (e.g. banks that have a security interest may have priority over the bank accounts and/or other assets of their customers).
- You have to determine whether or not the person (individual or entity) that executes the guaranty actually has sufficient funds and assets to pay your receivable.

Personal or Third Party Guaranties or Security Agreements can be added to the sale contracts, or they can be included in separate independent contracts.

3. Confession by Judgment

You may request from your client what is called a “confession by judgment” in the amount of the purchase price. In such case, the buyer will have to attest under oath that he/she/it owes you a certain amount of money, and that buyer will timely pay you by a certain date. Thereafter, in the event of payment default, you will be able to obtain a judgment from the court without starting a regular lawsuit, attending any hearing, or having to comply with the time consuming and expensive discovery process. The buyer will be declared “Judgment Debtor” and you will be able to enforce the Judgment against the Judgment-Debtor, as if you had actually prevailed at trial!

4. Letter of Credit

A letter of credit is a document issued by a third party, generally a financing institution, which stipulates its unconditional commitment to pay to the beneficiary (you) a certain sum if beneficiary timely produces certain documents indicated in the letter of credit.

However, even though you benefit from a letter of credit, you will still need a well prepared written sales agreement in order to reduce the payment risks.

Since banks usually freeze the sums corresponding to the amount of letter of credit (plus applicable banks fees) in their clients’ bank account prior to the issuance of a letter of credit, it is not always easy to obtain a letter of credit from a US based SME. However, if you are successful in obtaining a letter of credit, you should also note that:

- It is impossible to contest non-negotiable and irrevocable letters of credit or to modify their terms after their issuance. Therefore, insist on a non-negotiable and irrevocable letter of credit payable at sight.
- The sales contract:
 1. Must clearly specify that the payment will be pursuant a letter of credit.

2. Must incorporate a clause stipulating that buyer may not even attempt to stop the bank's payment after you produce the requisite documents. And that otherwise, you will be entitled to recover all your damages including any of your legal fees.
 3. Shall clearly indicate that in the event you are unable to comply with non essential terms of the letter of credit, the buyer will provide the bank and yourself with a written waiver under the letter of credit; and that buyer will exert its best efforts to cause the bank to pay you as indicated in the letter of credit.
- The payment date on the letter of credit should be defined in the sales agreement as "30 days", "30 days after acceptance", or "30 days after lading."
 - Banks must insure conformity of the documents you provide with what is stated in the letter of credit; banks are not responsible for conformity of the goods.
 - Unless fraud is suspected, the bank is required to pay you the amount indicated in the letter of credit provided you timely produce the documents listed on it.

Finally, you should be aware of the implications of the U.S Bankruptcy Laws. If a company is unable to honor its debts, it will be able to file for bankruptcy with a Federal Bankruptcy Court, most likely under the Chapter 7 or 11 of the US Bankruptcy Code.

Chapter 7: Under Chapter 7 of the Bankruptcy Code, the debtor's assets will be liquidated and the proceeds will be distributed to the debtor's creditors. The bankrupt company will cease all operations and will be dissolved. The distribution of the proceeds to the creditors will depend on their priority rights: A secured creditor (who is the beneficiary of a security agreement) will be paid before an unsecured creditor, and generally, unsecured creditors collect the smallest percentage of their receivable. For this reason, it is vital to secure your receivables with a security agreement.

Chapter 11: Unlike in Chapter 7, the company is not dissolved and continues to conduct business. The debtor is given a chance to prepare a plan to reorganize the company and to agree on a payment plan with the creditors while all or a part of the business continues.

After the debtor files for Bankruptcy under Chapter 11, the debtor has 120 days to present its plan of reorganization to its creditors and to the Bankruptcy Court. If the debtor fails to submit a plan within 120 days after its petition was filed, or if creditors refuse the debtor's payment plan during the first 180 days, any creditor can submit its own plan.

A plan of reorganization must include all classes of creditors including employees, professionals, secured and/or unsecured creditors. The plan of reorganization must clearly indicate the classes of creditors which will be paid, the payment offer and the date of payment. Each identified class must approve the debtor's proposed payment with a two-thirds majority in amount and more than one-half in number of the allowed claims in the

class. In addition, the Court must believe in the feasibility of the plan of reorganization and in the debtor's willingness to honor it.

In the event one or more classes of creditors reject the plan of reorganization, the debtor can nonetheless force them to accept it. This is called cram-down. Debtor can do this if debtor can prove that the creditors would collect less money in the case of dissolution than under its proposed plan of reorganization.

The debtor will only pay those debts as to which creditors have timely filed a proof of claim, subject to debtor's right to contest the same. Once the Court confirms the plan, the company will continue its activities but generally with much less debt.

When a company files for bankruptcy, any lawsuit or legal procedure directed against it is stayed. Further, no new legal action may be brought against it, and the creditors will only collect the amount of their approved payments.

By implementing the few pieces of key advice mentioned in this article, you will be able to significantly reduce the payment risk inherent in conducting business with US SMEs. The most important thing to remember is to know who you intend to do business with, and to enter into a well drafted sales agreement. Further, insist on obtaining a security interest from debtor and/or personal/third party guarantees from reliable persons/entities. These simple precautions will help you protect your interests and make the most of your sales to the huge and very lucrative US market. Good luck!



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