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PRACTICAL INFORMATION

HERMES COVER SPECIAL

Letter of undertaking – explanatory notes
(convenience translation)

EXPORT CREDIT GUARANTEES OF THE
FEDERAL REPUBLIC OF GERMANY

► **Hermes Cover**

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Letter of undertaking – explanatory notes

The exporter is required to sign a letter of undertaking in connection with each buyer credit cover. In certain cases, a subcontractor's letters of undertaking may also be necessary. Many questions arise with respect to the significance and specific content of these letters.

Part I of this brochure describes the purpose of the letter of undertaking and subcontractor's letter of undertaking. Part II contains answers to detailed questions which are frequently asked about individual clauses of these letters.

I. GENERAL INFORMATION

WHAT IS THE PURPOSE OF THE LETTER OF UNDERTAKING?

In the case of every export transaction with buyer credit cover from the Federal Government, the exporter is integrated into the contractual relationship between the bank and the Federal Government by means of the so-called letter of undertaking (LoU). The LoU contains the requirements that the exporter would also have to comply with under a supplier credit guarantee. In this respect, the exporter is not placed in a different position when financing its transaction by means of a federally covered financial credit than if it grants credit conditions to its customer and secures its business with a supplier credit guarantee from the Federal Government. This involvement of the exporter also enables the Federal Government to assume an abstract compensation obligation under the financial credit cover – in particular independent of any disruptions and deficiencies in the export business. The abstract nature of financial credit cover is likely to make a significant contribution to banks' willingness to provide financing.

IN WHAT CASES IS A LETTER OF UNDERTAKING REQUIRED?

The Federal Government is only willing to provide an export credit guarantee for loans if the financing of the transaction is in the interests of the German exporter. This is expressly stated in the LoU. An LoU of the German exporter must therefore be submitted for every transaction with buyer credit cover, regardless of whether the exporter itself has applied for cover for its export claim from the Federal Government or not.

WHAT IS THE MAIN CONTENT OF THE LETTER OF UNDERTAKING?

The exporter undertakes to provide the Federal Government and the financing bank with certain information on the export transaction of relevance for the buyer credit cover. At the same time, the exporter declares its willingness to assume liability towards the Federal Government if, in the event of a claim, the Federal Government is required to indemnify the bank in cases in which the exporter itself would not be entitled to an indemnification due to a breach of duty under a supplier credit guarantee.

This applies, for example, if the export transaction was concluded by corruption, the exporter has provided incorrect information on the origin of the goods with regard to the scope of delivery to be financed, or the foreign buyer fails to repay the loan on the grounds of defective or incomplete performance of the delivery or service contract and the warranty rights existing in this respect under the export contract.

WHAT PARTICULAR FACTORS MUST BE OBSERVED IN CONNECTION WITH THE SUBCONTRACTOR'S LETTER OF UNDERTAKING?

The subcontractor's letter of undertaking (S)LoU has been created for the purpose of extending the right of recourse to include the main exporter's subcontractor(s) if its creditworthiness is not considered sufficient for the possible recourse claim of the Federal Government. For this reason, a letter of undertaking by the main subcontractors is mandatory in trading transactions.

The wording of the (S)LoU reflects the fact that there is no direct contractual relationship between the subcontractor and the foreign buyer. For this reason, the subcontractor's reporting duties and co-liability are a priori confined to its share in the delivery transaction in contrast to the standard LoU. In view of these restrictions to the wording, the (S)LoU is also used in cases in which the German exporter is the subcontractor of a non-domestic main exporter.

WHAT SHOULD BE CONSIDERED IF A GERMAN EXPORTER SUPPLIES THE FOREIGN END CUSTOMER THROUGH THE INTERMEDIARY OF ANOTHER CONTRACTING FOREIGN COMPANY?

In this case, an (S)LoU is required from the German exporter and, in principle, also an LoU from the non-domestic company.

For a foreign company economically linked to it (e.g. subsidiary), the German exporter usually has to assume liability on a special form (so-called LoU - affiliated company). In this case, it makes no difference whether the economically affiliated company alone enters into the contract with the foreign customer, whether there are parallel contracts concluded by the German exporter and the affiliated company with the foreign customer, or whether the German exporter acts with its affiliated company in a consortium vis-à-vis the foreign customer. The German exporter covers the entire transaction with this declaration, which only has to be signed by it. This eliminates the time-consuming and consultation-intensive collection of signatures of the foreign affiliated companies on a German-language declaration.

An intermediary company acting on behalf of the customer (e.g. so-called EPC contractor) is not required to provide a separate LoU. In this case, the German exporter must submit an (S)LoU.

WHAT RISKS DOES THE LETTER OF UNDERTAKING INVOLVE?

The LoU does not entail any additional obligations above and beyond those applicable under a supplier credit cover. Accordingly, the exporter does not expose itself to any additional risks by signing the LoU if it executes the export transaction with commercial due diligence and in accordance with the terms of the contract.

WHEN DOES LIABILITY UNDER THE (SUBCONTRACTOR'S) LETTERS OF UNDERTAKING EXPIRE?

Liability under the (S)LoU ends with the expiry of the buyer credit cover, i.e. normally upon full repayment of the guaranteed loan receivable. A shortening of the term of the (S)LoU in individual cases is not possible. However, it should be noted that the liability obligations of the exporter/subcontractor under the individual clauses may end much earlier. For example, a liability obligation for defective delivery and/or performance pursuant to number 5 of the (S)LoU only exists under the condition that the foreign debtor is actually validly entitled to warranty rights vis-à-vis the vendor. Upon the expiry of the contractual or statutory warranty period, the Federal Government no longer has any right of recourse under number 5 of the (S)LoU. The Federal Government can also only assert a possible recourse claim under number 6 of the (S)LoU as long as the warranty period under the export contract runs (but at least two years). The duty to disclose any circumstances constituting an increase of risk in accordance with number 1.b only applies until full disbursement of the loan, meaning that the exporter itself is not required to monitor the financing transaction once the export transaction has been carried out and the final loan instalment has been disbursed.

WHAT IS MEANT BY “OBLIGATION TO INDEMNIFY ON FIRST WRITTEN DEMAND”?

If the requirements for an indemnification obligation under the (S)LoU are met, the exporter is required to indemnify the Federal Government in accordance with its duty of compensation under the buyer credit cover “on first written demand”. According to the wording, this means that in the event of damage, the exporter must pay compensation to the bank instead of the Federal Government.

Despite the inclusion of the words “on first written demand”, a (possible) payment obligation on the part of the exporter is not comparable to a guarantee in the customary sense. This is already reflected in the wording of the (S)LoU, which provides for various restrictions. In any case, it is the understanding of the Federal Government that the facts of the matter must be clarified before any claims are asserted against the exporter.

For example, in the event that the borrower refuses to repay the loan due to alleged poor delivery (number 5 (S)LoU), the Federal Government would not refer unchecked to the buyer’s pleas of defects, but would first check the plausibility of whether the exporter/subcontractor has a warranty obligation.

Only if there were substantiated evidence pointing to the existence of such liability would the Federal Government consider whether it held any recourse claims against the exporter, in which case it would also take due account of any arguments submitted by the exporter. Thus, in case of doubt, the bank would initially receive indemnification under the buyer credit cover before the Federal Government would pursue any recourse claims against the exporter after sufficient clarification of the factual and legal situation.

To date, number 5 (S)LoU has not had any practical relevance. As loan contracts are typically abstract in nature, no objections based on the export transaction can be legally asserted against the repayment obligation.

CAN THE WORDING OF THE LETTER OF UNDERTAKING BE MODIFIED IN INDIVIDUAL CASES?

The wording of the (S)LoU is generally applicable and binding. It is not possible to delete or modify individual parts of the wording.

II. SPECIAL QUESTIONS AND ANSWERS**WHY DOES THE FEDERAL GOVERNMENT REQUIRE INFORMATION FROM THE EXPORTER (OR, WHERE APPLICABLE, THE SUBCONTRACTOR) ON THE EXPORT TRANSACTION, ITS PROGRESS AND ANY AGGRAVATION OF RISK? (NUMBER 1 (S)LOU)**

Naturally enough, the exporter is the party most familiar with the export transaction and is therefore the main source of information not only for the bank but also for the Federal Government on the transaction which the Federal Government wants to promote by assuming the export credit guarantee. All information – in particular in connection with the submission of the documents triggering payment – must be correct and complete.

Prompt notification of any risk-aggravating factors during the loan disbursement period allows the Federal Government to intervene and limit the scope of cover under the buyer credit cover, among other things, by excluding those loan amounts not yet disbursed from cover provided that the corresponding deliveries have not yet been executed. This enables the Federal Government to limit its risk under the buyer credit cover.

WHAT NOTIFICATION DUTIES MUST BE OBSERVED UNDER THE (SUBCONTRACTOR'S) LETTERS OF UNDERTAKING? (NUMBER 1 (S)LOU)

A distinction must be drawn between the obligation to provide a correct and complete description of the export transaction (number 1.a), to report any risk-aggravating factors to the Federal Government (number 1.b) and to inform the Federal Government of the current progress of the export transaction and other factors relevant to the buyer credit cover.

The duty towards the vendor and the financing bank to completely and correctly describe the export transaction (number 1.a) applies only in the period during which an application for buyer credit cover is made and processed. The duty to report any risk-aggravating factors (number 1.b) expires upon full disbursement of the loan. On the other hand, the reporting duty towards the Federal Government (number 1.c) applies throughout the entire term of the loan but arises only when a corresponding enquiry is received from the Federal Government. It is up to the obligated party to assess under the (S)LoU as to how long it should retain any documents that it needs to prove compliance with its obligations.

TO WHAT EXTENT IS THE OBLIGATION TO PROVIDE A CORRECT AND COMPLETE DESCRIPTION OF THE EXPORT TRANSACTION LIMITED IF THE NOTIFYING COMPANY ITSELF HAS NOT APPLIED FOR ANY COVER FROM THE FEDERAL GOVERNMENT? (NUMBER 1.A (S)LOU)

In this case, the Federal Government expects the exporter to answer any questions from the applicant bank correctly and completely and, if necessary, to correct its answers to the bank in the event of any subsequent changes. However, it is not necessary for the exporter to offer this information unless it receives a corresponding enquiry from the financing bank. The same applies to subcontractors with respect to the (S)LoU.

UNDER WHAT CONDITIONS IS THE FEDERAL GOVERNMENT ABLE TO CLAIM INDEMNIFICATION IN CASES IN WHICH THE EXPORTER (OR THE SUBCONTRACTOR) FAILS TO COMPLY WITH ITS DUTY TO PROVIDE INFORMATION AND TO CORRECT ANY INFORMATION ALREADY SUBMITTED DURING THE APPLICATION PROCEDURE? (NUMBERS 1 AND 2.A (S)LOU)

The exporter (or subcontractor) is only liable if the buyer credit cover was granted precisely with regard to the incorrect or incomplete information, i.e. it would not have been granted if the actual facts had been known. In addition, the exporter's/subcontractor's failure to comply with its information duties must be reproachable ("aware or reasonably expected to be aware"): What is decisive in this case is what the employees of the exporter (or subcontractor) responsible for the export transaction in question were aware of or, on the assumption that the business structures are properly organised, could be reasonably expected to have been aware of with respect to the error or omission in the information.

As a fundamental principle, each party submitting information is liable only for any reproachable breach of duty of its own employees.

MAY THE FEDERAL GOVERNMENT ASSERT CLAIMS AGAINST THE EXPORTER (OR THE SUBCONTRACTOR) IN ALL CASES IN WHICH THE LATTER FAILS TO OBSERVE ITS DUTY TO NOTIFY THE FEDERAL GOVERNMENT OF ANY AGGRAVATION OF RISK OR OTHERWISE FAILS TO SUBMIT INFORMATION? (NUMBERS 1.B AND 1.C LOU, NUMBER 2.B (S)LOU)

No. Claims for indemnification can only be submitted if there is a causal link. In other words, the breach of duty on the part of the exporter must have caused the claim or must be expected to cause it. In the absence of any causal link between the breach of duty by the exporter and the claim under the buyer credit cover, the Federal Government cannot assert any claims against the exporter (or the subcontractor).

CAN THE FEDERAL GOVERNMENT LIMIT ITS CLAIM FOR INDEMNIFICATION IN FAVOUR OF THE EXPORTER? (NUMBER 3 (S)LOU)

Yes. Number 3 reflects the principle of proportionality: the Federal Government's use of the LoU must not be disproportionate to the exporter's breach of duty. It is at the discretion of the Federal Government to decide whether or not to assert any claims against the exporter under the LoU. A comparable provision also applies to supplier credit cover (Art. 16 (4) GC (G)).

WHAT HAPPENS IF AN EXPORT TRANSACTION HAS ARISEN ON ACCOUNT OF CORRUPTION? (NUMBER 4 (S)LOU)

The Federal Government is not permitted to provide any cover for export transactions brought about by corruption. During the application procedure for supplier credit cover, the exporter must also declare that the transaction has been brought about without any corruption. If this declaration subsequently proves to be untrue, the Federal Government will be relieved of any liability in the event of a claim and the premium paid will be forfeited.

For this reason, the (S)LoU includes a corresponding provision as the Federal Government is obviously not willing to support any financing for an export transaction brought about by corruption.

WHAT IS THE SITUATION IF THE DEBTOR REFUSES TO REPAY THE LOAN ON THE GROUNDS OF DEFECTIVE OR INCOMPLETE PERFORMANCE OF THE DELIVERY OR SERVICE CONTRACT? (NUMBER 5 (S)LOU)

Under supplier credit cover, the exporter does not receive any indemnification if the foreign buyer's complaints are justified (Art. 5 Paragraph 2, Sentence 2 GC (G)). Rather, the onus is on the exporter to prove that it is actually entitled to claim payment. For this reason, the Federal Government has a right of indemnification against the exporter under the (S)LoU if the foreign buyer refuses to repay the loan on the grounds of defective or incomplete performance of the delivery or service contract.

However, this occurs only rarely in practice as the debtor generally accepts the abstract nature of the loan, meaning that the claims held by the bank are honoured notwithstanding the defective or incomplete performance of the delivery or service contract.

In addition, the Federal Government will regularly compensate the bank and only then take recourse against the exporter, whereby the Federal Government would also take into account any objections asserted by the exporter.

WHAT HAPPENS IF SERVICES THAT HAVE ALREADY BEEN REMUNERATED BY DISBURSEMENT FROM THE FINANCIAL LOAN ARE NOT (OR WILL NOT BE) PROVIDED? (NUMBER 6 (S)LOU)

If the covered exporter has received funds from the buyer credit for services that it has not provided, this may give rise to a recourse claim of the Federal Government if the latter has to indemnify the bank. This recourse claim is intended to compensate the loss incurred by the Federal Government in cases in which the exporter achieves a financial advantage due to the incomplete fulfilment of the export contract (e.g. through saved expenses). This also creates a synchronisation with supplier credit cover where the corresponding amounts would not be indemnified in the first place.

The application of number 6 is only conceivable if the Federal Government is also liable under the buyer credit cover for disbursements before full performance of services. Only then it can be obliged to compensate, even though the corresponding services are still outstanding. Typical case groups are the so-called invisibly included services (services without own terms of payment, which are usually paid for via the payments for deliveries) as well as payments at an agreed latest date or according to project progress (so-called milestones). Depending on the size and the specific structure of the payment terms, the Federal Government assumes liability already from the respective disbursement (in accordance with

Art. 3 (1) GC (FKG)), so that theoretically the loss scenario described may occur and the Federal Government may be entitled to claim recourse under number 6. If, however, the commencement of liability is linked, via the inclusion of a so-called commencement of liability clause into the bank's cover document, to the actual performance of services, or if the terms of payment only provide for payments to be made after performance of the deliveries/services, then number 6 is not applicable.

When the Federal Government examines whether it is entitled to such recourse, the exporter has three months from the Federal Government's request to demonstrate the provision of the service (no indemnification on first demand). The depth of examination depends on the type and scope of the exporter's business operations. The Federal Government requires a comprehensible presentation of the facts of the case (no strict proof). The limitation of the recourse claim to the term of the warranty period under the export contract (at least two years) ensures that there is still a certain temporal proximity to the transaction.

WHAT MUST BE OBSERVED IF THE LOAN IS DISBURSED IN THE FORM OF PROGRESS PAYMENTS? (NUMBER 7 (S)LOU)

In the case of delivery contracts for which progress payments are stipulated, there is a heightened risk of disruptions in the delivery affecting the repayment of the loan. This risk would be borne by the Federal Government as the provider of cover for the loan. Accordingly, the exporter is also liable in cases in which it would not receive any indemnification itself under export credit cover (manufacturing risk cover in this case).

Under manufacturing risk cover, indemnification claims would only arise provided that certain conditions specified in greater detail in the General Terms and Conditions were satisfied. Whether the exporter has actually taken out manufacturing risk cover from the Federal Government in this specific case is irrelevant.

Number 7 applies only if the "progress payments" option is actually selected in the loan agreement and documented in the buyer credit cover (as a special condition).

WHAT PARTICULAR FACTORS MUST BE OBSERVED IN CONNECTION WITH CONSORTIA AND JOINT VENTURES? (NUMBER 8 LOU)

If the contractual partner of the foreign buyer is a consortium or joint venture/working group, the lead manager of the consortium (or a representative of the members of the joint venture) must submit the LoU on behalf of the other consortium members.

Although all parties are jointly liable towards their buyer under the terms of the applicable contract, their liability towards the Federal Government under the LoU is limited to the absolute amount of their quota share in the transaction. This provision also clarifies that the companies that are members of a consortium or joint venture are not held liable for the breach of duty of other members. If several participants are in breach of duty, each company is liable only for its own breach (and only up to the amount of its share quota). If only a single participant has breached a duty, it is solely liable, in which case its liability is also limited to its own share quota.

WHAT IS MEANT BY "JOINT AND SEVERAL LIABILITY"? (NUMBER 10 (S)LOU)

This refers to the fact that the Federal Government may, at its discretion, recover the amount owing either from the main exporter ("vendor") or the subcontractor in cases in which both parties are required to indemnify it for the same amount. Obviously, the Federal Government can only recover this amount once.

Export Credit Guarantees and Untied Loan Guarantees: instruments to promote foreign trade and investment provided by the



Federal Ministry
for Economic Affairs
and Energy

Commissioned to implement the federal
funding instruments Export Credit Guarantees
and Untied Loan Guarantees:



EULER HERMES

Cover from the Federal Republic of Germany for foreign business

Export Credit Guarantees and Untied Loan Guarantees as well as effective foreign trade promotion instruments of the Federal Government have been established for decades. Export Credit Guarantees (so-called Hermes Cover) protect German exporters and banks financing exports against political and commercial risks. Untied Loan Guarantees are to support raw material projects abroad regarded as eligible for promotion by the Federal Government. Both promotion instruments play an important role in fostering economic growth as well as in protecting and creating jobs. The Federal Government commissioned Euler Hermes Aktiengesellschaft to manage the federal funding instruments Export Credit Guarantees and Untied Loan Guarantees.

Information on other foreign trade promotion instruments of the Federal Government can be found at www.bundeswirtschaftsministerium.de/en under the heading Promotion of Foreign Trade and Investment.

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