

# Finance Update

**Welcome to Taylor Wessing's June 2007 update summarising what we think are the more interesting recent legal developments in banking and finance.**

## **Bonds: Redemption and the rights of the Trustee**

Unfortunately Law Debenture Trust Corporation plc and Concord Trust have been in the courts again. This time the dispute shows just how costs indemnities can bump up the obligor's liabilities and the importance of obtaining clear agreement as to the redemption amount when you want to redeem.

The facts: The case concerned a Eurobond issue of €510m 2 per cent bonds issued by Elektrim Finance BV and guaranteed by the third defendant. Law Debenture Trust was the Trustee. On 26 October 2006 the guarantor paid the Trustee the sum of €525m in response to the presentation of a bankruptcy petition in Poland by the Trustee. It was paid without any agreement between the parties about the amount required to redeem the bonds, about what was to happen to outstanding litigation in Poland and elsewhere, or about the payment of the costs and expenses which the Trustee then considered to be outstanding. At the time of the payment the Trustee had incurred costs in the earlier litigation against a number of the bondholders and interest had accrued on such costs. The bonds were secured and the guarantor wished for the security to be released. However, the Trustee calculated that there was a shortfall of some €1.5m on 26th October on the payment made by the guarantor in October. In addition it anticipated incurring further costs as it was still being included in various proceedings relating to Elektrim. As a result the dispute included: (a) whether the bonds had been redeemed; (b) whether the Trustee was obliged to release the security; (c) whether the Trustee was entitled to use the money received from the guarantor to discharge costs, expenses and remuneration already incurred and/or to provide a retention against future costs and/or liabilities; (d) whether the Trustee was obliged to distribute the monies to the bondholders; and (e) whether interest had continued to accrue on the bonds since 26 October 2006 and if so, at what rate.

The decision: The judge held that the bonds had not been redeemed since the full amount had not been paid and part redemption was not an option under the terms of the bonds. The bond conditions provided that the security would be released upon redemption of the bonds in full. However, the judge considered that the general principle that a trustee's right to indemnity and consequent lien or charge over trust assets 'trumped' the bondholders' entitlement to be repaid and Elektrim's right to redeem. Therefore the Trustee was entitled to retain a reasonable amount to cover the costs the Trustee considered it was likely (on reasonable but worst case assumptions) that it would in future incur as a result of its continued involvement in the continuing litigation elsewhere. However the balance was to be distributed to the bondholders without any further conditions that the Trustee sought to impose, namely indemnities from the bondholders. Moreover, until redemption in full the security could not be released and interest had been accrued on the bonds since October 26 2006 at the default rate as the bonds had not been redeemed and the issuer was in default of their terms.

Comment: This case shows the importance of drafting accurately. The bonds included a fairly standard clause on distributions providing for payment of the trustee's costs but only those then due yet the security could be released once the bonds were redeemed so the Trustee had been rightly concerned it might never recover its future costs. However it also shows the importance of agreeing redemption amounts. By the time the case came to court the shortfall had increased to over €17m owing to the accrual of interest. Whilst the Elektrim payment had been placed in an interest bearing account it in no way matched the default rate of 8% that was held to be accruing on the bonds. It will be interesting to see if this case results in more borrowers and guarantors trying to insert provisions that ensure that once a part payment has been made then no further interest shall accrue on that part in excess of the rate earned on the deposit. Whilst such attempts might be successful in relation to bilateral loans (where the relevant bank does at least have the benefit of the money), it is hard

to see a syndicate agreeing to this where the Agent holds the money and they have nothing until they finally receive payment. One can also see how important a costs clause is to a trustee. A lot of the costs incurred were as a result of the dispute between the Trustee and the bondholders which has been reported in previous updates and went all the way to the House of Lords. However, the issuer was still liable to pay them, even though it was not directly involved. However, seeing such costs rack up means that no Agent/Trustee is going to agree to any borrower or issuer's attempt to restrict what can be recovered.

*Law Debenture Trust Corporation plc v Concord Trust and others [2007] EWHC 1380 (Ch)*

## Syndicated Facilities: Transfers and sub-participations

It is relatively rare for there to be litigation surrounding agency or security trust language so for there to be two cases reported in one month is highly unusual. However this further case serves as a reminder that the Agent in a syndicated facility is just that and will bind the bank syndicate when it enters into agreements as agent. It also examines the extent to which sub-participations are caught by transfer provisions in syndicated loan agreements.

The facts: As part of a general restructuring of British Energy's finances, a bank syndicate agreed to write off about £340m of principal debt with the remaining £150m being governed by a new credit facility and the claimants agreed to grant options to purchase the shares in or assets of Eggborough Power Limited (which owned the Eggborough power station) in accordance with two option agreements. The two option agreements were virtually identical; and were entered into by the Buyer, which was Barclays Bank plc, as 'agent and security trustee' for the banks. The banks included Credit Suisse which by the time the matter came to court, through various transfers had rights in relation to about 90% of the interests of the banks and therefore satisfied the definition 'Majority Banks' on its own.

The option agreements specifically prohibited the Buyer from entering into any agreement or other arrangement that related to the exercise of any of its rights under the option agreements or to assign, transfer or declare a trust of the benefit of or in any other way dispose of all or any of the Options Shares other than in accordance with provisions which gave EPL a right of pre-emption to acquire the assets for 105% of the price and on the terms the Buyer had agreed with a third party would be purchaser.

The loan agreement provided that commitment or rights under the finance documents could only be transferred or assigned to another bank or credit institution or an spv whose entire share capital is owned by banks and financial institutions and even then subject to the prior consent of the borrower unless the transferee or assignee was already a Bank, an Affiliate of a Bank or an OECD Bank.

The price of electricity rose and so therefore did the value of the options. An investment bank, Greenhills, put together a structure to sell the option by consolidating existing sub participations with Credit Suisse, transferring them to an SPV, Ampere Limited, in exchange for entry by Credit Suisse as grantor into a single sub-participation with Ampere under which, most importantly, Credit Suisse would be bound to exercise its rights to instruct Barclays to exercise the rights under the Option Agreements at the request of Ampere. British Energy considered this to be in breach of the terms of the option agreement and began proceedings.

The decision: The judge held that Credit Suisse, as a Bank was bound by the agreement since Barclays had been expressly appointed in the restated loan agreement to execute the option agreements as agent for the banks including Credit Suisse and, in accordance with established case law, there was nothing to render the restrictions void as being contrary to public policy. Moreover, entry by Credit Suisse into the scheme proposed by Greenhill would constitute a breach by Credit Suisse of the terms of the option agreements.

Comment: In some ways this was a 'one-off' transaction in that the transfer provisions, particularly in the option agreements, were far more restrictive than one would see in a typical syndicated facility. This was, as the judge pointed out, because British Energy was keen to prevent its assets from falling under the control of a rival and, as the judge commented, banks normally do not own, let alone operate power stations and therefore could be 'expected to be far more circumspect in deciding whether or not to exercise an Option'. However, if nothing else the case acts as a reminder that, when entering into a transfer or sub-participation, it is not enough to review the transfer provisions in the loan agreement.

Unfortunately, the way the judgment deals with sub-participation is not very clear. At one stage the judge seems to suggest that sub-participations were not permitted which contradicts market practice which is to accept that they are permitted unless they are expressly prohibited and also appears to contradict British Energy's submission that sub-participation of the Loan was envisaged. Moreover, as the reference to transfers and assignments in the loan agreement spoke of any part of the Commitment 'and/or any of its rights and/or obligations under the Finance Documents' (with Finance Documents including the Options) one has some sympathy with Credit Suisse's arguments that this was inconsistent with the Option transfer provisions, even though this was rejected by the judge.

It must also have been a bit of a disappointment for the LMA to learn that the judge considered, having seen 18 of the sub-participations involved, that he considered 'there is no consistency, let alone market practice, in the commercial terms of the sub-participations' since one imagines they would have hoped that their standard forms are used in most instances. However, the unusual nature of this transaction where options were exercisable, might account for a more bespoke form being used in this instance.

*British Energy Power & Energy and others v Credit Suisse and others [2007] EWHC 1428 (Comm)*

## Insolvency: Business Rates

The decision in Trident Fashion (May Update) is already having an effect in that a recent case involves the administrators of a company applying to the court for directions in relation to changing the company from being in administration into creditors' voluntary liquidation ("CVL").

The facts: The company was an insolvent toy retailer operating out of a number of stores, two of which were empty. As a result of the Trident Fashion case, the administrators were concerned that unoccupied property rates (in this case some £5,000 per month) would be treated as an expense of the administration whereas they would not be an expense of the liquidation and therefore wanted the company to move from administration to liquidation. Compulsory liquidation would lead to charges of £100,000 but paragraph 42(2) of schedule B1 of the Insolvency Act 1986 provides that no resolution for a CVL may be passed while the company is in administration. The administrators did not want to resign before as then the assets would be handed back into the control of the directors.

The decision: The judge interpreted paragraph 79(1) of schedule B1 widely and considered the court had the power to provide for an administrator's appointment to cease at any specified time and not merely in the more restrictive circumstances described in paragraphs 79(2) and (3). He therefore made an order discharging the administrator upon the passing of a resolution to wind up the company voluntarily.

Comment: As the second ground for the appointment of an administrator is achieving a better result for the creditors as a whole than through a winding up, where there is vacant property, it will be much harder to satisfy this limb making liquidation more likely.

*Re T M Kingdom Ltd (in administration) (unreported)*

## Banking: Guarantees

A recent case shows that guarantors who agree to be primary obligors are well and truly on hook once the principal debtor defaults.

The facts: Five shareholders guaranteed the performance by their company of a supply contract. Once the company was in default, the beneficiary of the guarantee issued statutory demands which the guarantors tried to have set aside on the ground that no demand under the guarantee had been served prior to service of the statutory demands. The guarantors argued that they could not be said to be unable to pay their debts under ss 267 and 268 of the Insolvency Act 1986 since cl 2 of the guarantee provided that 'the guarantor shall pay to the beneficiary on demand' the amount unpaid by the company and without a demand there was no debt. The district judge agreed with the guarantors so the beneficiary appealed.

The decision: The judge agreed with the company that the guarantors' liability under the guarantee was immediately payable without the need for a demand as the guarantee provided in cl 1 that they were liable 'as primary obligors' in addition to the provisions in clause 2. As a result the statutory demands were effective.

Comment: In many ways this decision is potentially very harsh for guarantors. On the facts, the shareholders were involved with the company and knew that there had been a breach of the supply contract, writing to the beneficiary on the date that liability arose under the guarantee referring to the guarantee and asking for a little more time. However, where the guarantor is less actively involved in the activities of the principal debtor, it seems a little harsh that the first they can hear about it is when they receive a statutory demand. Whilst it is unlikely that most beneficiaries of guarantees would adopt such an approach, a prudent guarantor might try to draft to avoid this. However, to do so might have the knock on effect that its ability to set off in the insolvency of the beneficiary as established in the MS Fashions Ltd v BCCI decision would also be lost. Moreover, any beneficiary would be unlikely to accept any amendment that might undermine the imposition of a primary obligation on the guarantor since this potentially provides valuable protection against the unenforceability of the guaranteed obligation.

*TS & S Global Ltd v Fithian-Franks and others [2007] All ER (D) 171 (Jun)*

## Banking: 'Cov-Lite' agreements

The Association of Corporate Treasurers has written to the Treasury Select Committee inquiring into private equity stating what they consider 'Cov-lite' really means. Despite the name they consider that typical 'Cov-lite' agreements still contain extensive covenants. To read the letter itself please go to <http://www.treasurers.org/purchase/customcf/download.cfm?resid=2302>

## Banking: Capital Adequacy

The CML has published a report on the issues faced by mortgage lenders in the UK in complying with the Basel 2 requirements, the potential impacts on capital and the changes that may occur in the UK mortgage market. It is available on the CML website at <http://www.cml.org.uk/cml/publications/research>

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## Mortgage Lending: Draft directive on Consumer Credit

The CML has published an overview of the legislative process and key implications for mortgage lenders of the draft directive on consumer credit. The report is available on the CML website at <http://www.cml.org.uk/cml/policy/issues/144>

## Projects: PFI

A new report 'Building on success: the way forward for PFI', published by the CBI assesses use of the PFI to date and states that extensive savings and efficiencies have been reaped by the public sector, noting that since the PFI's creation in 1992, almost 800 PFI deals have been signed, bringing £55bn of private investment. This includes more than 230 new or fully refurbished schools, involving £2.3bn of investment, 39 PFI hospitals projects, bringing £5.3bn of investment to the NHS, 58 transport projects, 41 waste and water projects and 180 other projects in sectors including defence, leisure, culture and social housing. Moreover, in local government, PFI schemes will have brought in £19bn of investment by 2008, with almost 150 local authorities involved in PFI projects.

The report adds that the inclusion of 'soft services' such as cleaning and catering in PFI contracts has been highly successful. It says separating these services from the construction of public buildings would result in poorer long-term planning and could damage value for money for the taxpayer.

To read the report itself please go to

<http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/08f071861b44e1a4802572f1004ab635?OpenDocument>

## Securitisation: recording how this is treated in national accounts

Eurostat, the Statistical Office of the European Communities, has published guidance on the recording, in national accounts, of securitisation operations undertaken by general government. To read the decision itself please go to

<http://europa.eu/rapid/pressReleasesAction.do?reference=STAT/07/88&format=HTML&aged=0&language=EN&guiLanguage=en>

## Private equity

Those involved in Private Equity were no doubt relieved to learn that the FSA in its published feedback to Discussion Paper 06/6 Private Equity: A discussion of risk and regulatory engagement, views private equity as an important and growing part of a dynamic and efficient capital market. Moreover the FSA apparently considers it has correctly identified and prioritised those risks and that their current approach to supervising this market is broadly appropriate. The feedback statement is available at

<http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/071.shtml>

## Companies Act 2006: Directors' duties

On 26 June 2007, the DTI (which since then has changed its name to the Department for Business, Enterprise and Regulatory Reform) published a statement by Margaret Hodge, Minister of State for Industry and the Regions, giving guidance on directors' duties under Part 10 of the Companies Act 2006. Unfortunately it just consists of extracts from statements previously made and provides no practical guidance such as to how directors are expected to record compliance with their duties since all practitioners are still unsure as to precisely what should go into board minutes when the new rules come into effect in October. To read the report, please go to

<http://www.dti.gov.uk/files/file40139.pdf>

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