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BANKING NEWS



PREPARING FOR DEFAULT – CONSIDERATIONS FOR LENDERS

In the current economic climate it is important that lenders are prepared to react to any borrower default and are aware of the consequences of calling a default.

Whilst every default situation is unique, what follows is a broad overview of the considerations for lenders, should such a situation arise.

Identifying a default

We recommend early review of all facility and security documentation. It is important that you are aware of both the borrower's, and your own, rights and obligations under such documentation.

Some common default situations are non-payment, breach of financial or other undertakings and breach of financial information requirements. However, the borrower may be in breach of the security documents as well as the facility agreement itself.

It is important to be clear which events of default you are relying on, as these often overlap. If the default is capable of remedy, you should also confirm whether it has been remedied and, if not, the date on which the period within which it can be remedied expires.

Challenges to calling a default

The underlying obligation breached, or the event of default itself, may be limited by materiality. This could provide the borrower with a potential challenge to your decision to call a default. The risk of such a challenge can be reduced if the borrower confirms that the default has occurred.

The borrower is usually obliged to notify you of any default of which it becomes aware.

Effects of calling a default

It is usual that in a default situation a lender may (i) cancel its obligations under the facility letter, (ii) require immediate repayment of the outstanding loan together with accrued interest and all other sums due (iii) charge default interest and/or (iv) enforce any security granted on account of the borrower's obligations.

Acceleration of the loan may cause a previously solvent borrower to become insolvent. If the borrower is unable to pay debts as they fall due, the borrower, any lender or other creditors may start insolvency proceedings.

If formal insolvency proceedings are started, all other legal action against the borrower (including the

enforcement of security) must stop while an insolvency practitioner seeks to resolve the insolvency or liquidate the assets of the borrower.

Although the proceeds from the liquidation of any assets which are subject to security will be applied first to satisfy secured creditors, the value of the borrower's assets individually may be less than their value as a going concern. As the process will be controlled by the insolvency practitioner, your influence as secured lender will be somewhat restricted.

Alternatives to calling a default

You may wish to consider whether it is in your interests to call a default at all. It may be the case that the loan can be restructured. Additional security, revised payment mechanisms and/or more stringent financial covenants may be sufficient to protect your position and allow your relationship with the borrower to continue.

If you believe that a default has occurred, make sure that you understand the borrower's position and maintain a dialogue with the borrower throughout the resolution process. Early discussions with your advisers are also essential in order to fully understand and evaluate your position.

THE BANKING ACT 2009



The Banking Act 2009 (the "Act") came into force on 12 February 2009 and is viewed as the biggest shake up to the banking industry for more than a decade.

The Act includes provision for faster pay outs under the Financial Services Compensation Scheme ("FSCS"), enhancement of the information gathering right of the Financial Services Authority ("FSA"), and provision for the short term non-disclosure of financial assistance given to banks by the Bank of England ("BoE"). There are also new bank administration and insolvency procedures, largely based on the administration and liquidation procedures in the Insolvency Act 1986.

The Act's core provisions establish the first permanent statutory regime aimed at dealing with failing banks, replacing the interim powers used to nationalise banks like Northern Rock, and setting out a clear legal framework within which regulators may exercise intervention powers when a bank is in difficulty.

The Special Resolution Regime ("SRR") makes it easier for regulators to step in when a bank is struggling and stabilisation options allow the regulators to effect a private

sector transfer, a bridge bank transfer, or take the bank into temporary public ownership. In order to facilitate the transfer of the shares or the business of a failing bank, the Act contains extensive powers for regulators to make orders for share or property transfers.

The SRR is a last resort; it will be triggered only if the FSA decides that a bank is failing or is likely to fail its threshold conditions and has no reasonable prospect of remedying that position. The FSA will retain a supervisory role thereafter and the BoE will implement and run the regime, except in cases of temporary public ownership where the Treasury assumes responsibility.

The Act affirms five statutory objectives: to protect and enhance the stability of the UK financial system and confidence in the UK banking system, to protect depositors and public funds and to avoid interfering with property rights. Any action taken under the SRR must have regard to at least one of these objectives.

A Code of Practice supporting the legal framework of the SRR and providing guidance as to how and in what circumstances the regulators can use the special resolution tools was published by HM Treasury on 23 February 2009 following consultation with the FSA, BoE and FSCS.

On 30 March 2009, the first use of the Act was to transfer the Dunfermline Building Society's assets to Nationwide Building Society. Following significant deterioration in the financial position of Dunfermline, the BoE conducted a competitive sale process. The BoE, having consulted the FSA and Treasury, considered the overall package offered by Nationwide to best meet the objectives of the SRR.

The Banking Act 2009 aims to maintain financial stability and restore confidence in the banking system, as well as continuing to foster greater cooperation and coordination between the FSA and BoE.

COMPANIES ACT 2006: REGISTRATION OF COMPANY CHARGES

The Companies Act 2006 (the "Companies Act") received Royal Assent in November 2006 and is being implemented in stages, with all provisions due to be in effect by 1 October 2009.

Part 25 of the Companies Act relates to registration of company charges, but the good news is that there are no radical changes to the current law. The categories of charge which require to be registered and the 21-day registration period have not changed but there have been certain amendments to the current regime as regards registration.

The main changes include new section numbers and new forms to be sent to the Registrar of Companies.

Changes have also been made in respect of overseas companies. Currently, foreign companies with a place of business registered in the UK are required to be registered at Companies House and, accordingly, are required to register charges with the Registrar of Companies. In addition, the *Slavenburg* ruling provides that charges created by companies registered outwith the UK over property situated in the UK require to be registered at Companies House where the Registrar of Companies enters brief details in the 'Slavenburg Register'.

Under powers conferred by the Companies Act, the Secretary of State has drawn up draft regulations (the "Regulations") creating a single regime for registration and filing for overseas companies that establish a place of business, including a branch, in the UK. The Regulations require overseas companies which have a place of business in the UK to register specific charges with the Registrar of Companies but such regulations do not

include a requirement for registration by companies not registered in the UK.

Accordingly, with effect from 1 October 2009 Companies House will no longer be accepting *Slavenburg* registrations, in respect of charges created on or after 1 October 2009.

Charges created by UK registered companies will still require to be registered at Companies House. The Companies Act essentially restates the provisions of the Companies Act 1985 in relation to floating charges, namely that in order to be valid against an administrator or liquidator or any creditor of a company in the event of insolvency, a floating charge must be registered with the Registrar of Companies within 21 days of its creation.

Changes may, however, be implemented when the relevant provisions of the Bankruptcy and Diligence etc. (Scotland) Act 2007 (the "Bankruptcy Act") come into force. The Bankruptcy Act provides for the establishment in Scotland of a new register of floating charges, to be held by the Keeper of the Land Register of Scotland and states that a floating charge will only be created on its registration in this register. This will mean that there will be a double registration requirement for Scottish floating charges - registration in the register of floating charges and, within 21 days of that date, registration at Companies House. There has been considerable debate as regards the practicalities of this requirement and it is thought likely that the Secretary of State will make an Order enabling charges registered in the Scottish register of floating charges to be treated as being registered with the Registrar of Companies, hence removing the double registration requirement.

SUPER-PRIORITY FUNDING TO BE CONSIDERED

The Government has announced that it intends to consult on the question of awarding "super-priority" to funders of companies in administration and/or subject to company voluntary arrangements.

The term "super-priority" is usually used in connection with funding provided at a time when a company is insolvent and subject to a statutory moratorium. The key feature of such a regime is that providers of new finance are awarded priority over all pre-existing creditors.

The Government's current interest in this issue no doubt arises from a desire to be seen to be actively encouraging the rescue of the ever-increasing numbers of insolvent businesses by encouraging bankers to become involved in funding such rescues.

This is not the first time that the UK Government has considered the issue of super-priority status and in the past,

the idea has always been rejected. One of the main policy objections may be that such a regime may actually force more companies into insolvency than might otherwise have been the case. After all, lenders will be aware that if they await a formal insolvency before providing funds, they will be in a better position than if they advance funds at an earlier stage.

On the other hand, the fact that no super-priority is currently available may be actively discouraging lenders from offering facilities to such companies in an effort to rescue the corporate shell. Indeed, it has been suggested that this has increased the likelihood of pre-pack sales out of administrations which (rightly or wrongly) seem to be widely perceived as detrimental to creditors as a whole.

The outcome of the consultation process will be eagerly awaited. Whichever way the Government decides to go, this issue will have profound effects for the UK economy.

FINANCIAL COVENANT EVENTS OF DEFAULT

In current market conditions, financial covenants are likely to be the subject of increased focus for both lenders and borrowers as they are commonly the first event of default to be triggered when a borrower's financial position deteriorates.

Financial covenants monitor such factors as net worth, leverage and interest and cashflow cover and are included in facility agreements as a protection for the lender, ensuring that the financial condition, business and assets of the borrower remain within certain parameters based on the bank's assessment of the borrower prior to lending. These also give an early warning to the lender of deterioration in the financial health of a company.

A breach can have a substantial impact on the borrower, both in terms of the resultant actions of the lender and through cross default; creditworthiness and possible wrongful trading and challengeable transactions. The lender will, amongst other remedies, be entitled to refuse to make further advances; demand the borrower takes action to perfect and protect security; exercise greater control over the borrower's assets and possibly accelerate the loan.

Both lenders and borrowers need to be aware of the issues surrounding financial covenant events of default

and the consequences these can have. Particularly, both should be mindful of the link between the covenant itself and the information against which it is tested.

During the period leading up to a test date, there can be little certainty as to whether a default will occur, even if management accounts suggest that this will be the case. This is because the performance of the borrower for the remainder of the period cannot be predicted with complete accuracy.



The period following the test date but prior to delivery of financial information can contain further uncertainty. A lender would be unlikely to call an event of default before receiving the financial information but may claim that a potential event of default exists or demand that the borrower confirm that it is not aware of any breach. The response to such a request requires to be carefully drafted if there is an indication at that point that there is a breach.

Only on delivery of financial information will there be conclusive evidence that a breach has occurred and this will have to be confirmed in the certificate accompanying the information provided.

Similarly a borrower's obligation to provide a budget forecast as part of its financial information undertakings must be complied with even where this will indicate a possible breach

later in the period, albeit that usually an event of default cannot be said to have occurred until a test date has passed or the relevant financial information has been delivered.

A lender frustrated at waiting for the opportunity to call an event of default may consider whether it is able to do so under a material adverse change event of default. Whether or not it can do so will depend on several factors. The wording of the relevant clause will be paramount. The well-advised borrower should be able to take advantage of materiality, objectivity and generality to ensure that there is sufficient uncertainty preventing the lender from relying on such an event of default. The borrower's own circumstances will also impact on the possibility of there being a material adverse affect event of default. In certain instances, where there has been a single cataclysmic event, there may be little room for disagreement.

On the whole however, most lenders would prefer to wait for the certainty that a financial covenant event of default has occurred.

If the borrower's financial position rapidly deteriorates to the point that it is unlikely to be able to pay its debts as they fall due or to avoid formal insolvency, then immediate advice should be sought as other events of default might be triggered and statutory duties and responsibilities to wider stakeholders will become relevant.

It is important that a borrower receives legal advice on reports, budgets and forecasts that are to be provided to a lender to ensure that it doesn't inadvertently admit to an inability to pay its debt, as this in itself could be enough to allow the calling on an event of default under the wording of certain insolvency based events of default.

Issue Contributors:

Frances Sim (Editor)

Alan Meek

Johanne Watson

Rachel Hinds

Fiona Armour

Fiona Masterton

macROBERTS

Glasgow

152 Bath Street, Glasgow G2 4TB

Tel: 0141 332 9988 Fax: 0141 332 8886

Edinburgh

Excel House, 30 Seple Street, Edinburgh EH3 8BL

Tel: 0131 229 5046 Fax: 0131 229 0849

website

www.macroberts.com

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For further information, please e-mail the editor, Frances Sim at: frances.sim@macroberts.com