

INSIDE THIS ISSUE

HOW TO SOLVE A PROBLEM LIKE FUNDING AN SME?

GUARANTEE OR NOT GUARANTEE - THAT IS THE QUESTION!

VAT FREE SAMPLES

RESPONSIBLE LENDING IN THE MORTGAGE MARKET

FILING FOR ADMINISTRATION - GET IT RIGHT OR ELSE!

DEALS ROUND-UP

macROBERTS

Winter
10/11

BANKING NEWS

HOW TO SOLVE A PROBLEM LIKE FUNDING AN SME?

On 1 November 2010, the Government published its response to the green paper, "Financing a private sector recovery". The green paper outlined the Government's concern over the lack of funding available to small to medium sized enterprises ("SMEs") - a problem identified in its summer Budget Report - and explored a range of options for improving access to finance for these enterprises. Prior to publishing its response, the government sought the views of businesses, individuals and financial institutions on the paper.

The predominant concern identified in the green paper, and by the 183 respondents thereto, was the lack of access for SMEs to debt and equity markets. Other issues raised were the need to assist SMEs in becoming more investment ready, the problems faced by SMEs in accessing trade finance and the relationships between SMEs and banks.

The response outlines a number of measures and initiatives designed to address the various issues identified, including:

- **Increasing Transparency in the Banking Sector** - The Government will support and encourage the banking sector in introducing a set of measures designed to improve the transparency and credibility of bank commitments in their dealings with SMEs. The proposed measures include: revising the lending code to incorporate new commitments to micro enterprises and to extend the lending principles for larger SMEs; introducing a new internal appeals process which will be independently monitored; and introducing commitments to provide guidance pre-application and personalised feedback and signposting on declined credit applications.
- **Continuation of the Enterprise Capital Funds programme (the "ECF")** - The ECF supports investment in early stage innovative SMEs with the highest

growth potential. It puts public money alongside private equity investment in order to enhance private investors' expected returns and attract them to invest. The Government has committed to continue the ECF programme through the next four years, providing more than £300 million of investment.

- **Continuation of the Enterprise Finance Guarantee (the "EFG")** - The EFG supports lending to viable small businesses that have insufficient collateral or financial history to access commercial debt finance. The Government will continue to support the EFG scheme for the next four years, providing, subject to demand, more than £2 billion of investment.
- **Standardisation of the framework for future UK securitisations** - The Treasury, the Bank of England, and the Financial Services Authority (the "FSA") are to work with the industry to consider the creation of a more standardised framework for future UK securitisations. The aim is to improve the appeal of securitisations to a wider range of investors.
- **Increasing access to debt capital markets** - Debt capital markets are widely viewed as out of the reach of SMEs, being regarded as an appropriate finance option for larger businesses only. However, the response notes that there is scope to widen access to bond

markets and privately-placed debt to smaller businesses. The Government is to actively support the industry in taking further steps to promote the development of corporate debt capital markets in the UK and in making these markets more widely accessible to SMEs.

- **Increasing access to trade finance** - The response recognises that the availability of trade finance is of central importance to the UK's economic growth. The Government is considering a number of proposed steps to increase access to trade finance for SMEs, including: working with the British Banking Association (the "BBA") to explore the possibility of introducing a guarantee scheme similar to the EFG for businesses seeking working capital to fund exports; working with the BBA and exporter groups to consider how an Export Credit Guarantee Department bond support scheme might operate for British exporters; and working with the banking sector to increase awareness of the trade finance products currently available to SMEs.

Despite the wide range of measures and initiatives proposed, the response does not propose any specific legislative changes - the majority of the measures outlined are envisaged either as extensions of existing schemes, or initiatives that require further assessment prior to implementation.



GUARANTEE OR NOT GUARANTEE - THAT IS THE QUESTION!

In the absence of a clearly drafted document, the question of whether a guarantee is in fact a performance (or on demand) bond often arises - a problem accentuated by the recent market practice of including indemnities, conclusive evidence clauses and on demand payment clauses in contracts purporting to be guarantees.

The distinction is an important one. A guarantee is a promise to perform a contract or to ensure that a contract is performed following the default of the primary obligor. It is a secondary obligation, the guarantor's liability being contingent upon the liability of the primary obligor.

In contrast, a performance bond is a direct primary undertaking to pay a specific amount to someone on the occurrence of a particular event, most often triggered by the production of a notice specifying the amount due and demanding payment thereof.

Performance bonds were originally developed as specialist banking instruments for trade finance transactions. Given this, there exists a presumption that where such contract is not granted by a bank in a banking context, it does not amount to a performance bond (*Marubeni Hong Kong and South China Limited v the Mongolian Government* [2005] EWCA Civ 395).

This distinction had, however, become hard to draw in the wake of *IIG Capital LLC v Van Der Merwe & Anor* [2008] EWCA Civ 542. In this case the Court of Appeal provided that a directors' guarantee containing wording commonly used in guarantees throughout the market was, by virtue of this wording, a performance bond, rebutting the presumption referred to above (see our Knowledge area at www.macroberts.com for MacRoberts Banking Law e-update - Guarantors - Be Warned! from 02/07/08 for further case details).

In 2010, in *Carey Value Added, S.L. v Grupo Urvasco, S.A.* [2010] EWHC 1905 (Comm), the High Court sought to distinguish the IIG case and held that there was a stateable case that a document did not amount to an on demand bond where:

- although expressed as primary obligations, the obligations of the guarantor were co-extensive with the obligations of the principal under the underlying documents;
- the primary obligations of the guarantor became effective only when due by the principal; and
- the guarantor's indemnity was qualified to the extent of the principal's liability to the lender and as such was also co-extensive and was not unqualified.

In the recent case of *Vossloh Aktiengesellschaft v Alpha Trains (UK) Ltd* [2010] EWHC 2443 (CH) it again fell to the High Court to consider the distinction. In this case *Alpha Trains (UK) Ltd* ("*Alpha*"), a train operator, entered into a series of contracts with *Vossloh Locomotives* ("*Vossloh*") under which *Vossloh* was to manufacture, operate and service trains for *Alpha*. *Vossloh Aktiengesellschaft* (the "*guarantor*"), the parent company of *Vossloh*, provided a guarantee (the "*guarantee*") to *Alpha* in relation to *Vossloh's* obligations under the contracts.

Alpha subsequently complained that a large number of the locomotives supplied to it by *Vossloh* had defects. *Alpha* claimed that *Vossloh* was liable for a sum in excess of €17 million for breach of contract and sought to recover this amount from the guarantor under the guarantee. The defects were not admitted by *Vossloh* and liability under the contracts was the subject of separate proceedings. Therefore, the guarantor argued that nothing was owed under the guarantee until breach of contract by

Vossloh as primary obligor had been established. *Alpha*, however, claimed that guarantee was on its true construction a performance bond which obliged the guarantor to pay the sum demanded immediately without proof of default by *Vossloh*.

As the guarantor is not a bank, the question before the High Court was whether the facts of the case and the language of the guarantee were enough to rebut the presumption that the contract was not a performance bond.

The High Court held that despite the inclusion of an on demand payment clause, a waiver of defences clause and a conclusive evidence clause, that the guarantee did not amount to a performance bond. In particular, the critical factor was that the guarantee was drafted on the premise that a default by *Vossloh* had occurred. This meant that the guarantor's obligations were secondary, supported by primary obligations which only came into effect following default by *Vossloh*. It, therefore, followed that any obligation on the part of the guarantor to make payment to *Alpha* was contingent on the outcome of the proceedings regarding *Vossloh's* liability.

The decision in this case therefore follows on from the *Carey* case providing much needed clarification on the distinction between a guarantee and a performance bond.

In light of these decisions, beneficiaries and guarantors should seek legal advice before entering into a guarantee or on demand bond in order to ensure that the document is clearly drafted so as to have the intended legal effect.

There is limited authority on this subject in Scotland, however, it is likely that the above case law would be persuasive authority in the Scottish Courts.



VAT FREE SAMPLES

In autumn 2010 the Court of Justice of the European Union ("the ECJ"), ruled that the UK VAT legislation as applied to the provision of business samples is incompatible with EU legislation. The ruling in the case of *EMI Group Ltd v HM Revenue & Customs* (Case C-581/08) is good news for businesses who have accounted for VAT on business samples as they may now seek a refund of VAT from HM Revenue & Customs ("HMRC").

Under EU VAT legislation, the distribution

of samples for business purposes (such as marketing, advertising or other similar purposes) is not treated as a supply for the purposes of VAT. However, under UK legislation, where there is a series of business samples distributed to the same person, the exception is restricted to the first sample and the business distributing the samples must account for VAT on all subsequent samples.

Between April 1987 and June 2003 *EMI Group Ltd* ("*EMI*") distributed free copies of music recordings on vinyl records, cassette tapes and compact discs to influential people in the media and music

RESPONSIBLE LENDING IN THE MORTGAGE MARKET

Over recent months, the financial services industry has published various responses to the FSA's July 2010 Consultation Paper 10/16 (CP 10/16) "Mortgage Market Review - Responsible Lending". Such responses raise concerns about the direction, impact and timing of the FSA's proposals.

CP10/16 focuses on lenders' decision making processes and the ability of consumers to repay their mortgages. It outlines the changes that the FSA believes are necessary to encourage lenders to adopt a more responsible approach to lending.

THE FSA'S PROPOSALS

1. Affordability Assessments

Affordability Assessments will be required for all mortgage applications. These will be based on a capital and interest repayment profile, even if the mortgage in question is interest only. In addition, the assessments will assume a maximum term of 25 years, though the actual term of the mortgage may be longer.

New rules requiring lenders to take expenditure into account when assessing affordability are also proposed and mortgage payments will be tested against interest rate increases, to ensure that the assessments are robust.

A more stringent affordability test will be applicable to customers with a credit-impaired history with lenders required to apply a "buffer" to any calculation of such individuals' disposable income. The FSA is seeking suggestions on the form of the "buffer" and how it should be calculated.

2. Income Verification

Verification of borrowers' income will be required in every case, effectively ending self-certification and fast-track mortgages. Whilst the FSA does not prescribe the form of verification required, it does state that it must be from a source independent of the consumer and should be sufficient

to enable the lender to assess the risks posed by the individual circumstances of the consumer.

The FSA has said that it would expect firms to consider factors such as employment status, employment history and credit history. Lenders will also need to ensure that appropriate documentation is retained on client files to be able to demonstrate that appropriate information on income has been retained even where the mortgage has been arranged through a broker.

3. Interest only mortgages

The FSA considers it fundamental that customers should be able to afford to repay their mortgages and wants lenders to check that there is a repayment vehicle in place. Unless that repayment vehicle is guaranteed, it would like lenders to monitor the repayment vehicle throughout the term of the loan.

The commercial realities of interest only mortgages are such that the FSA has not yet proposed any changes prohibiting or limiting the availability of interest only mortgages.

THE INDUSTRY'S RESPONSE

The key concerns raised by industry bodies include the following:

- Shifting responsibility for validating repayment methods from borrowers to lenders will not help borrowers to make well-informed decisions;
- Compliance costs for lenders, and the regulatory risk of lenders making judgments on the adequacy of the



repayment methods, may be prohibitive;

- Too many creditworthy borrowers will be denied access to mortgages - it is recognised that some 50% of home loans made between 2005 and 2009 would not be allowed under the proposed mortgage market review;
- Transitional arrangements will be required to provide for consumers who have historic mortgages which lie outwith the proposed criteria; and
- The proposals will make it more difficult for individuals to obtain mortgages, ultimately resulting in greater detriment to the housing market.

Further concerns have been expressed that the FSA is developing its proposals against a backdrop of significant prudential and supervisory change in the financial services sector. The outcome of current reforms is likely to have a significant impact on the future regulation of the mortgage market.

NEXT STEPS

The FSA plans to publish its policy statement on CP10/16 in the first quarter of 2011 and has not ruled out further mortgage market reform if the initial proposals do not have sufficient effect.

industry, such as journalists and those working in radio, television, advertising, retail and cinema. EMI also distributed multiple recordings free of charge to promoters known as "pluggers" who distributed the recordings to their own contacts. EMI considered these distributions to be for business purposes, as it allowed EMI to assess the commercial quality of the recordings and to influence the level of exposure of new releases.

Prior to 2003, EMI accounted for the VAT on the samples it distributed in accordance with the UK VAT provisions relating to business samples. In July 2003, EMI formed the view

incompatible with EU law and ceased to account for VAT on the free recordings it distributed and asked HMRC to refund the VAT it believed it had overpaid.

HMRC refused to refund any VAT and issued EMI with an assessment for the VAT on the free recordings distributed since July 2003. EMI appealed this decision at Tribunal, challenging the compatibility of the UK provisions relating to business samples with European law. The Tribunal referred the question of compatibility with EU law to the European Court of Justice (ECJ). The ECJ determined that a sample was an item intended to promote sales and that the

sample need not be presented in a way which was not available for sale.

The ECJ accepted that the UK could set a limit on the value of "small gifts" given as samples, currently £50, but it did not accept that, when determining whether that limit had been breached, the value of gifts given to more than one employee within the same organisation should be aggregated.

This decision opens the door for tax payers who have accounted for VAT on business samples to make a claim for overpaid VAT. Such a claim can cover a four year period.

FILING FOR ADMINISTRATION - GET IT RIGHT OR ELSE!

Since 2003, the procedure for appointing administrators has largely consisted of filing simple forms with a court. What could be easier?

A recent case has, however, highlighted the dangers of making errors in the filing process and serves as a timely warning to everyone involved in insolvency and security enforcement work.

In *Kaupthing Capital Partners II Master LP Inc*, the English courts ruled that an appointment of administrators was invalid as the incorrect form had been used for the appointment.

Kaupthing Capital Partners II Master LP Inc ("Kaupthing") was a legal entity established in Guernsey. When Kaupthing's parent entered insolvency proceedings in 2008, Kaupthing itself was not long in following and, on 9 October 2008, forms were filed in the English courts for the appointment of joint administrators.

Pillar Securitisation SARL ('Pillar') had acquired some of the debt due by Kaupthing and made various applications to the court in respect of the administration. The most significant of these applications was a challenge to the validity of the appointment of the administrators and was based on two grounds:

1. The Centre of Main Interests ('COMI') of Kaupthing was Guernsey and so the English courts did not have jurisdiction to deal with the insolvency; and
2. Even if the English courts did have jurisdiction, the method used to appoint the administrators was invalid.

On the COMI point, the court held that Kaupthing's COMI was in England (notwithstanding the Guernsey registration) and accordingly the English courts had jurisdiction.

On the issue of the method of appointment of the administrators, the court considered the specific forms that



had been filed. Kaupthing was a limited partnership established in Guernsey under the Limited Partnerships (Guernsey) Law 1995. A Form 2.10 (the prescribed form for a company) had been used for the appointment. It is worth noting that there is currently no prescribed form available for use specifically for UK limited partnerships. The administrators argued that Kaupthing (being a Guernsey limited partnership) was to be considered as a hybrid -

somewhere between a partnership and a company and accordingly that a Form 2.10 was the appropriate form.

The court held however that a Form B1 (the prescribed form for a partnership) should have been used instead. As a result, the court held that the appointment of the administrators was invalid.

The court made reference to the earlier decision in *G-Tech Construction Ltd* in which the parties faced a similar invalidity issue. In *G-Tech*, the court had made a retrospective appointment of administrators. In *Kaupthing*, however, the court decided that although they had the power to back-date an appointment, it would not do so here, as such new appointment would have dated back to October 2008. As the case was heard after October 2009, any administration would have automatically expired after 12 months - so there was no point in now making such an appointment.

This case therefore emphasises the importance of firstly, using the correct forms when filing for an administration; and secondly, ensuring the forms are then completed correctly. The warning is clear, if you do not use the correct form or get the details wrong, you might find that an administration that you had believed had commenced never actually came into being at all.

At MacRoberts we have an experienced team who can assist in all stages of administration appointments. If you require any assistance in this area please contact Alan Meek or John Reid.

DEALS ROUND-UP

- Acting for The Royal Bank of Scotland plc in connection with its provision of funding totalling £40m to Albyn Housing Society. The funding will be used to re-finance existing facilities and to build 400 low-cost homes in the Highland area.
- Acting for RBS Invoice Finance Ltd in providing facilities for acquisition of business and assets of Forth Wines Ltd from Matthew Clark Ltd. The acquisition was made by three experienced operators in the wine business.
- Acting as Scottish counsel for Hydrex Equipment (UK) Ltd in connection with the accession of its Scottish subsidiary companies to their recently restructured banking facilities provided by a syndicate led by Barclays Bank plc.
- Acting for new client Goldentree Financial Services plc, who specialise in bridging finance.
- Acting for Santander UK plc in connection with the provision of property investment funding of approx £4m and £1m to two limited partnerships, with supporting security.
- Acting for HSBC Bank plc in the provision of facilities of £2.52m to Epoch Property Ltd, with supporting security over business park property in Uddingston and Blackpool.
- Advising Barclays Bank plc in connection with the provision of facilities to Allied Holdings (UK) Ltd with supporting security over industrial property.

MacRoberts publishes regular e-updates regarding various aspects of corporate and commercial law. If you would like to receive, free of charge, a copy of any of these publications, please register for the topics of interest to you by logging on to www.macroberts.com/e-updates

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