Banking update.

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Takeover Panel Practice Statement 25: debt syndication during offer periods

The Takeover Code (the "**Code**") includes a requirement that information about companies or other persons involved in a takeover offer must be made equally available to all target company shareholders. Additionally, in the context of an offer under the Code, arrangements should not be entered into with one or more shareholders which are more favourable than those being extended to all shareholders. Those rules can cause concerns where debt financing is being raised in connection with an offer and the providers (or potential providers) of all or part of that debt financing hold (or may in the future hold) shares in the target of the offer.

The Takeover Panel (the "**Panel**") has published a Practice Statement which provides clarity on how the Panel suggests the market ensures that the Code is not breached in the process of a debt syndication that takes place during an offer period. The LMA has issued a revised confidentiality and front running letter for primary syndication which includes language for use in the situations envisaged by the Practice Statement.

The Code

Rule 20.1 of the Code is designed to ensure that shareholders receive equal information. During an acquisition financing a lender (or transferee) may well receive information that was not made available to shareholders generally, such as due diligence reports, detailed financial information about the target and business plans. If that lender or potential lender also holds (or may in the future hold) shares in the target, then there is the potential for a breach of Rule 20.1.

> The Practice Statement provides clarity on how the Takeover Panel suggests the market ensures the Code is not breached.

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Establishing information barriers

The Practice Statement which is reflected in the revised LMA confidentiality and front-running letter provides a means of alleviating the concerns that the Code may be breached during a syndication. It enables providers and potential providers of debt finance to confirm that they (and their affiliates) are not (and will not become) holders of shares in the target or that they (and their affiliates) have in place suitable information barriers between the debt finance part of their organisation and the part of the organisation which deals with equity investments.

Minimum standards for effective information barriers

The Panel has set out its minimum standards for effective information barriers between a debt finance provider's equity department and its debt department. The Panel expects the offeror's financial adviser and the mandated lead arrangers to take all reasonable steps to ensure that potential transferees during the offer period satisfy these minimum standards. Permanent information barriers are more likely to be effective than ad hoc ones, so if it is proposed that ad hoc barriers are established, the Panel should be consulted. The criteria established by the Panel are:

- **Personnel**: the debt and equity departments of the relevant entity should have separate personnel, they should not share offices and, if possible, each department should be physically separated from, and not be capable of being accessed by, the other department. The Panel will normally be prepared to disregard members of senior management and compliance staff for these purposes, provided they do not participate in investment decisions relating to the proposed transaction and do not share non-public information about the transaction with persons who are involved in making those investment decisions;

- **Technology and systems**: each of the two departments should be prevented from accessing non-public documents created, edited or received by the other department. Computers and other electronic equipment used by one department should not be used by, or accessible to, the other department; and

- **Ring-fencing of information**: internal files, records and other non-public deal information prepared by each of the departments should not be used with, or be capable of being accessed by, the other department.

Kirsty Thomson and Andrew Stanfield, London

Recent changes to the LMA investment grade facility agreement

In April 2009 the Loan Market Association (the "**LMA**") released an updated form of its investment grade facility agreement. The vast majority of the changes were made to conform parts of the LMA investment grade facility agreement with the LMA's leveraged facility agreement. This article explains the principal changes which the LMA has introduced.

Confidentiality obligation for finance parties

Until this change, the LMA investment grade facility agreement has not imposed an express confidentiality obligation on the finance parties. The reason was that banks have a duty of confidentiality imposed by the common law and so this was seen as unnecessary.

However, it is unclear whether this duty extends to non-banks and the scope of the duty itself may be uncertain. In leveraged facilities, where the syndicate members are often funds or other investors rather than banks, a confidentiality undertaking was included to clarify that the obligation should apply to all finance parties and the extent of the obligation.

Investment grade facility agreements have not typically included such a provision. Typically only banks participate in investment grade syndicates but, particularly with larger syndicates, this may not always be the case. To accommodate this, and with free transferability of loans being increasingly required, the LMA has included an equivalent express confidentiality undertaking in its investment grade facility agreement.

The undertaking itself amounts to an obligation on each finance party to keep confidential information confidential, not to disclose it and to protect it with security measures and a degree of care that the relevant finance party would apply to its own confidential information.

There are a number of exceptions to the confidentiality undertaking allowing disclosures to certain classes of person (such as sub-participants) upon the satisfaction of conditions, which vary depending on the persons to whom information is to be disclosed.

Numbering service providers

The LMA has included a provision allowing certain limited disclosures to be made to numbering service providers, which are entities, such as Markit, that allocate unique identification numbers to facility agreements, to facilities available under facility agreements or to obligors party to facility agreements. That unique number is used to facilitate trading in relation to the relevant facility or facility agreement.

The information that may be disclosed to numbering service providers is limited to descriptive information, such as the type of facility, the size of facility, its ranking and maturity date. This is because the numbering service providers are not subject to confidentiality obligations so once a disclosure to them is made, the relevant information is public. The information is also limited so as to limit the risk of that information amounting to unpublished price sensitive information. By keeping the information relatively descriptive that risk is minimised, though the LMA has also included a representation by the obligors that such information is not unpublished price-sensitive information to give additional comfort.

New right to replace lenders

The LMA has inserted in its investment grade facility agreement a new right for the borrower to replace a lender that claims under the tax indemnity, increased costs and/or tax gross-up provisions. This right is in addition to the existing rights of repayment and cancellation in these circumstances.

The right of replacement allows a borrower to transfer all of the affected lender's rights and obligations to a willing transferee lender selected by the borrower. The purchase price is calculated to be the outstanding principal amount of the outgoing lender's participation together with any accrued interest, break costs and other amounts due.

It is worth noting that the borrower cannot replace the agent nor does the agent or any of the lenders have any obligation to find a replacement lender.

Amendments to tax provisions

There have been a number of changes to the tax provisions in the LMA's investment grade facility agreement, though these have not generally changed the substance of these clauses.

One notable change is the inclusion of a new requirement for lenders that become parties to the agreement after it is signed to confirm in the relevant transfer or assignment document whether they are qualifying lenders (including treaty lenders), just treaty lenders or neither of these. If a lender fails to give that confirmation, it is treated as if it is not a qualifying

lender (even if it is in fact one) until it gives such a confirmation to the agent. This is relevant since depending on that lender's status it may find its ability to rely on the tax gross-up provisions impaired.

The other changes to the tax provisions conform the tax gross-up and VAT provisions to the LMA's leveraged facility agreement and reflect the fact that the corporation tax rules are now set out in the Corporation Tax Act 2009. The Corporation Tax Act 2009 restated, with minor changes, certain enactments relating to corporation tax with effect from 1 April 2009 and so required a number of statutory references in the LMA's standard facility agreement to be updated.

Allocation of interest in mid-interest period loan transfers

Under the new LMA investment grade facility agreement the agent will now have the flexibility to enable it to distribute interest pro rata between lenders that transfer loans mid-interest period. The provisions also allow pro rata distributions of fees in this scenario. The outgoing lender is entitled to fees and interest up to but excluding the date on which it transfers its loan and the new lender is entitled to those payments from the date of transfer. Payments will be made on the relevant interest payment date.

Changes to the negative pledge

The new LMA investment grade agreement includes a new definition of "Quasi-Security" covering the existing restrictions on quasi-security arrangements in the negative pledge. This definition is used to extend the carve-outs in the negative pledge to quasi-security as well as security. Two new carve-outs are also inserted – an exception for retention of title arrangements and a carve-out to allow payment or close-out netting or set-off on hedging transactions in the ordinary course of trading and managing interest rate exposures.

"…with free transferability of loans being increasingly required, the LMA has included an equivalent express confidentiality undertaking in its investment grade facility agreement."

Alternative method for transfers

The LMA investment grade facility agreement has traditionally used novation as the mechanism for loan transfers. This is a clean way for a new lender to step into the shoes of an existing lender because it allows for rights (for example, the right to be repaid) and obligations (such as to fund participations in new loans) to move across to the new lender in a tried and tested way. A transfer certificate documents a transfer by novation.

However, some civil jurisdictions do not recognise a novation in the same way as it is seen under English law. It may also be preferable to use assignment rather than novation if the borrower is insolvent. Leveraged facilities have for some time therefore included an alternative method to effect transfers. This involves an assignment of the rights of the outgoing lender to the new lender (most importantly the right to repayment of loans together with interest and fees) accompanied by a statement by the new lender confirming that it assumes the obligations of the old lender (such as the obligation to participate in new advances of a revolving facility). An equivalent alternative method now appears in investment grade facilities and requires the addition of a form of transfer certificate to the schedules of the LMA's standard facility agreement which documents a transfer effected by assignment.

Lenders need to remember to seek local law advice with regard to how transfers involving other jurisdictions are best effected to ensure that the end result is an effective transfer.

Other changes

The LMA has also made the following changes to its investment grade facility agreement:

- conforming the guarantee provisions to the LMA's leveraged facility agreement in the way that they express the indemnity obligation that is given by guarantors, the wording of the guarantee clause that deals with the reinstatement of released obligations in the context of insolvency proceedings and to impose further restrictions on guarantors exercising rights against other obligors before the loan is repaid in full;

- adding an express carve-out to the insolvency proceedings event of default to allow for winding up petitions that are frivolous or vexatious and discharged within a certain period;

- including provisions relating to security over lenders' rights, which allow lenders to use loans as security for their own obligations owed to, for example, a central bank;

- updating the provisions setting out the duties of the agent and its ability to appoint a nominee;

- inserting provisions that expressly state that the agent may treat each lender of record at the opening of business on a particular day as the entity entitled to receive, or obliged to fund, any payments under the facility agreement on that day;

- allowing each lender to appoint a person to receive notices and other communications on their behalf, so that any lender which is a fund may have information filtered via such a person so it need not receive private information if it does not wish to;

- amending the provisions concerning the redistribution of payments that finance parties receive from obligors otherwise than in accordance with their entitlement under the facility agreement; and

- adding to the list of matters that require all lender consent any amendment or waiver which relates to the nature or scope of the guarantee and indemnity provisions.

Suggested changes to the LMA investment grade facility agreement addressing the consequences of a lender becoming insolvent or defaulting on its obligations under the facility agreement, the agent becoming insolvent or otherwise unable to perform its duties, the mechanics of setting LIBOR and the market disruption provisions were also released by the LMA in June 2009. These are discussed separately in this edition of Banking Update.

Andrew Stanfield, London

Changes to the LMA's standard documents in response to the credit crisis

Autumn 2008 witnessed a series of high-profile bank collapses including Lehman Brothers and the Icelandic banks Landsbanki, Glitnir and Kaupthing. Unprecedented in their scale and reach, and set in the context of the ongoing credit crunch and high funding costs eroding lending banks' margins, these situations and the accompanying turmoil in the world's financial markets caused many participants in the loan markets to analyse the terms of their lending arrangements. Many, whether borrower, lender, agent or otherwise, were directly affected by these events and needed to look at their loan documentation to establish their rights and obligations in this scenario. More generally, the concern that similar events could occur in respect of other banks prompted the market to re-assess whether lenders and borrowers are adequately protected under their facility agreements.

The LMA's response

In response, the Loan Market Association (the "**LMA**") concluded its consultation on this in June 2009 and released revised versions of its standard form facility agreements. It included new provisions in its leveraged documentation and issued a user's guide to the inclusion of these provisions in its non-leveraged documentation. The key changes it introduced concern the consequences of a lender becoming insolvent or defaulting on its obligations under the facility agreement, the agent becoming insolvent or otherwise unable to perform its duties, the mechanics of setting LIBOR and the market disruption provisions.

Defaulting lenders

If a member of a lending syndicate becomes insolvent, a principal concern is that it will no longer fund its share of utilisations under the facility agreement. This concern applies both to new money loans and, usually, rollover loans.

A facility agreement based on the previous LMA form requires the borrower to repay and redraw the rollover loan, which in turn requires each member of the syndicate to fund its participation in that drawing. Cashless rollovers were not permitted under the terms of that facility agreement, even if they were done in practice. Following the collapse of Lehman Brothers, many market participants looked carefully at their facility agreements to understand whether they were permitted to perform a cashless rollover and avoid the risk of the borrower repaying the full amount of a rollover loan, but receiving back an amount less the defaulting lender's participation.

The new LMA facility agreement includes a provision explicitly requiring the agent to apply new revolving facility loans in repayment of maturing revolving facility loans, with the borrower only being required to make an actual cash payment to the extent the amount of the maturing revolving facility loans exceeds the amount of the new revolving facility loans. Similarly, the revolving facility lenders are only required to make an actual cash payment to the extent that the amount of the new revolving facility loans exceeds the amount of the maturing revolving facility loans. This provision only assists if the loans are rolled over. If revolving facility loans are repaid and redrawn at a later date the borrower is likely to receive an amount less the defaulting lender's participation.

To address this point, the LMA has included a new optional extension mechanism whereby, if a lender becomes a defaulting lender, the maturity date of that lender's participations in any outstanding revolving facility loans will be automatically extended to either the end of the availability period for the revolving facility or the termination date for the revolving facility and treated as separate loans. In this situation the borrower has the right to prepay any such separate loans and thereby remove the defaulting lender. This right is important as otherwise the borrower does not have the general right to prepay individual lenders and instead any prepayments are required to be applied pro rata across the lenders.

The borrower may also wish to remove the defaulting lender from the syndicate and the new LMA facility agreement therefore includes several provisions to address this. It includes the right for the borrower to replace a defaulting lender, the right for the borrower to cancel the available commitment of a defaulting lender and a new "increase" clause whereby other lenders may assume the commitment of a defaulting lender whose commitment has been cancelled. This last provision is intended to allow a new lender subsequently to be brought into the syndicate if one has not been identified at the time of the cancellation.

One of the aspects which may be sensitive for lenders is the trigger for these provisions. Largely covered in the new definition of "Insolvency Event",

this definition sets out the circumstances in which a lender is considered to be in financial difficulties. This definition is based on the corresponding definition in the standard ISDA Master Agreement, with the aim of achieving consistency in the market and using a concept which already has currency. While the definition will be recognised by those dealing with the ISDA documentation regularly, it may be less familiar to those on lending desks. It may therefore require tailoring, depending on individual circumstances, to ensure it only triggers these provisions in narrowly defined situations such as a lender being placed in administration.

Where the loan consists of fully-drawn term debt and there is no revolving facility, the funding concerns discussed above will be less of a concern. However, regardless of the nature of the facilities and whether they are drawn, the insolvent lender is unlikely to be discharging its other responsibilities under the facility agreement promptly, such as responding to consent or amendment requests, which may remain an important point and cause the parties to wish to exercise some or all of these provisions.

During the period while a lender is a defaulting lender, under the new LMA facility agreement it will not be entitled to receive a commitment fee. This reflects the fact that in practice it is unlikely that a defaulting lender would fund its participation in a new loan requested during that period.

Voting rights

Under a facility agreement based on the previous LMA form, the agent is required to take into account the commitments and participations of all relevant lenders for voting purposes. This means that the commitments and participations of any defaulting lender will continue to be taken into account for these purposes.

To address the concern that it may be inappropriate to count the vote of a lender which is not performing its obligations under the facility agreement, the LMA has amended its standard facility agreement to remove the right of a lender which is a defaulting lender to vote on decisions taken by the lenders under the facility agreement to the extent of that lender's undrawn commitment. The distinction is drawn between the defaulting lender's drawn and undrawn commitment on the basis that the lender should be entitled to vote to the extent that it already has a drawn exposure. Conversely, if it has an undrawn commitment, it should not be entitled to vote.

Practically, there may also be an issue for the agent in communicating with a defaulting lender and establishing how it wishes to vote. Some facility agreements include a snooze and lose clause, entitling the agent to disregard for voting purposes the commitment and participation of any lender whose consent it seeks but who does not reply to the agent within a specified timeframe. An insolvent lender is unlikely to be in a position to respond to communications promptly and so could find its vote excluded by virtue of the application of a snooze and lose clause. Relatively common on leveraged financings, the LMA leveraged facility agreement already includes a snooze and lose clause which may be included if appropriate.

Letters of credit

Where a LMA-based letter of credit option has been included in a facility agreement, the issuing bank which 'fronts' the letters of credit is reliant on the reimbursement obligations of the other lenders in the syndicate to make it whole if a payment under the letter of credit is made and the borrower has defaulted on its reimbursement obligation. If one of those lenders becomes insolvent, the issuing bank faces a risk for which it has not been remunerated – that the relevant lender will fail to perform its reimbursement obligation, leaving the issuing bank out of pocket.

The new LMA facility agreement includes a new right for the issuing bank to require any revolving facility lender to provide cash collateral upon the occurrence of certain trigger events, including a fall in that lender's credit rating below a set level. By holding cash collateral, the issuing bank is protected from the defaulting lender failing to comply with its reimbursement obligations.

If a lender which has been asked to provide cash collateral fails to do so, under the new LMA facility agreement the issuing bank may require the borrower to provide it instead. If the borrower does not provide cash collateral, the issuing bank may reduce the face amount of letters of credit to take into account the proportion of those letters of credit not cash collateralised. In conjunction with this, the new LMA facility agreement provides for the defaulting lender's commitment to be disregarded for the purpose of the indemnity provided by the revolving facility lenders.

Impaired agent

Where the agent becomes insolvent, the principal concern is that monies paid through it, whether by the lenders or the borrower, may be trapped with the agent as a result of it having entered into insolvency proceedings. In this situation the parties are likely to wish to replace the agent as quickly as possible. They may also need to consider how they may best make payments which are due either before any such replacement or on an ongoing basis if the relevant institution is not removed as agent.

Under the agency provisions of the previous LMA standard form facility agreement the agent has the right to resign voluntarily. There is also an alternative route whereby the majority lenders have the right, after consultation with the borrower, to require the agent to resign. The borrower has no right to require the agent to resign.

In practice, neither of these methods is an ideal way to replace an insolvent agent. The agent is unlikely to resign voluntarily in a prompt manner if it is engaged in insolvency proceedings. For the majority lender right to be exercised, the lenders must consult with the borrower and determine that there is majority lender support before they can replace the agent themselves. This may take some time to establish, particularly as the entity which in normal circumstances would run the process to seek majority lender instructions is the agent. The agent is unlikely to be in a position to run this process, or at least not swiftly, and the other lenders may face difficulties in establishing who should run this process and whether they have sufficient information about the other lenders in the syndicate to be able to run this process. Finally, a resignation notice signed by the agent will be required before the resignation can take effect and it may be difficult to obtain this signature if the agent is insolvent.

The new LMA facility agreement addresses these issues by including a new right for the majority lenders to replace the agent without requiring a resignation notice signed by the outgoing agent in order for the resignation to take effect. Instead, the appointment of the new agent and replacement of the outgoing agent takes effect on the date specified in the majority lenders' notice to the outgoing agent.

Payments while agent is impaired

The new LMA facility agreement includes several options intended to assist payments to be made to the relevant parties without requiring them to go through the agent whilst the agent is in insolvency proceedings.

It includes an option for the borrower to make payments direct to the required recipient.
In conjunction with this, it includes a requirement for the agent to provide to the borrower on a monthly basis a list of the lenders of record in the syndicate, together with their contact information and account details. This is intended to assist the borrower who can only make payments to the lenders if it knows the identity of those lenders, although it is not a perfect solution because there may have been transfers since the date the last list was provided.
It also includes an option for the borrower to make payments to an account held with a bank with a minimum credit rating and in respect of which no insolvency event has occurred and is continuing.
The account would be designated as a trust account for the benefit of the parties beneficially entitled to the payment and payments into this account will discharge the borrower.

It is envisaged that these options could operate in tandem, so the borrower could make payments to some lenders direct and other lenders via an appropriate account.

LIBOR/EURIBOR

As the credit crunch escalated, the gap between screen-based LIBOR/EURIBOR and the true cost of funds for banks in the market became wider. Concerns were widely expressed that screen-based LIBOR and EURIBOR were, at least for a while, not necessarily indicative of the true cost of funding in the London or European interbank markets.

In the context of a facility agreement based on the previous LMA form, LIBOR/EURIBOR is defined as the screen rate displayed by Reuters or, if the screen rate is unavailable, the rate determined by a group of three or four reference banks. If the screen rate does not reflect the true cost of funds for the lenders, this may be inappropriate. The new LMA facility agreement therefore includes changes to the definitions of LIBOR/EURIBOR which allow the parties the option either to choose the current LMA position (i.e. to have the screen rate as a primary method, with reference banks being used when the screen rate is unavailable) or simply to fix LIBOR/EURIBOR based on the rates quoted by a number of reference banks, and not use the screen rate.

If the facility agreement is used in conjunction with an ISDA master agreement, this may result in a mismatch between the way LIBOR is set under the ISDA documentation, which will refer to a screen rate, and under the facility agreement, which may now refer only to a rate quoted by reference banks.

The LMA has also made some changes to these definitions to tie them more closely to the British Bankers' Association's requirements for setting LIBOR. For example, they now refer to the rate at which the relevant reference bank "could borrow funds" in the relevant interbank market rather than the rate for the "offering of deposits". There is also a requirement for the deposits to be in "reasonable market size".

Market disruption

The LMA's standard form loan agreements include market disruption clauses, which are designed to protect lenders' margins from being eroded as a result of their cost of funds being higher than the rate set by the agent.

Under a facility agreement based on the previous LMA form, once a market disruption event occurs, the interest payable by the borrower to each lender during the relevant interest period includes the costs to the lender of funding its participation in the relevant loan from whatever source the lender may reasonably select. This means that, instead of paying one rate reflecting LIBOR or EURIBOR to all the lenders, a borrower will pay an amount that is the aggregate of each lender's cost of funds, the margin and any mandatory cost. The agent then distributes the payment received from the borrower such that each lender receives a separate amount that reflects its actual cost of funds.

The consequence of this is that a loan may become expensive for the borrower and administratively cumbersome for the agent. Therefore, to redress this, as soon as a market disruption event occurs, either the agent or the borrower can require the parties to enter into negotiations for up to 30 days, to try to agree another way of determining the interest rate.

The new LMA facility agreement inserts a further step between the occurrence of a market disruption event and the agent setting the interest rate to include each lender's cost of funds. This would, following the occurrence of a market disruption event, require the agent to approach a number of "alternative reference banks" to obtain an alternative rate. That group of alternative reference banks would be set out in a schedule to the facility agreement and would be a wider group than the three or four banks forming the base reference banks (i.e. the reference banks referred to in the definition of LIBOR/EURIBOR).

If none or only one of the alternative reference banks supplies a quote or a specified threshold of lenders notify the agent that they are unable to obtain funding at the alternative reference bank rate, there would be an alternative market disruption event. Upon the occurrence of an alternative market disruption event, the interest rate applicable would then be calculated in the same manner as set out in the current form of the market disruption clause (i.e. to include the costs to each lender of funding its participation in that loan from whatever source the lender may reasonably select).

Under a facility agreement based on the previous LMA form the agent may pass on information that it receives under the facility agreement in its capacity as agent. The agent could (but is not required to) disclose to other syndicate members that a lender has asked to invoke the market disruption clause. The new LMA facility agreement includes wording that gives parties the option to choose whether to state specifically that the agent is not obliged to, or may not, disclose to any finance party any details of the rate notified to the agent by any other lender, or the identity of any such lender, for the purpose of the market disruption clause.

Recent turmoil in the world's financial markets caused many participants to analyse the terms of their lending arrangements.

Conclusion

This release by the LMA provides a wide-ranging and welcome set of changes. Market reaction remains to be seen, but indications are that these provisions will be built into facility agreements to a greater or lesser extent. Parties are likely to consider whether it is appropriate, depending on the circumstances of the particular transaction, to include all or only some of these changes.

Kirsty Thomson, London

New guidance on execution of documents

New guidance on how documents may be executed has been published following the decision in *R (on the application of Mercury Tax Group and another) v HMRC* [2008] EWHC 2721.

The decision in the *Mercury Tax* case, which was discussed in the last issue of Banking Update, has led parties to consider whether the legal formalities required to execute their documents are such that they must sign the final version of the document, rather than attaching pre-signed signature pages to the final version of the document once it is agreed. Practice in the wake of the *Mercury Tax* case has differed, sometimes resulting in logistical difficulties on transactions. The Law Society Company Law Committee and The City of London Law Society Company Law and Financial Law Committees have therefore prepared guidance on these issues, to help develop a degree of conformity in market practice.

The guidance sets out three options that are available to facilitate virtual signings or closings where some or all of the signatories are not physically present at the same meeting and identifies the types of document for which each option may be used. It is expressed to be non-exhaustive and acknowledges that other methods of execution could be just as effective.

The first option

The first option is available when signing all types of document, including deeds and guarantees. This method of execution envisages that the agreed form document will be sent by email to the absent signatory. The signatory prints just the signature page to the document and signs it. The signatory then scans the signature page and sends an email back to its lawyers which attaches the scanned copy of the signature page and the agreed form of the document. In the case of deeds, it will also be necessary to make clear when delivery is to take place or to make clear that a deed has not been delivered merely because it has been signed and the steps set out above followed. At or shortly after the signing or closing, one of the law firms may circulate a final version of the document with copies of the executed signature pages in order to evidence execution of the agreed form of the document.

> "...the requirements for the execution of a deed are different to the requirements for other types of documents."

The key point to note in relation to this option is that the guidance makes clear that the requirements for the execution of a deed are different to the requirements for other types of documents. When arranging for a deed to be signed by an absent signatory, only this option may be used. Since the steps under this route require an agreed document at the time of signing, the guidance indicates that it is not possible to execute deeds using pre-signed signature pages.

The second option

The second option is available when signing all types of document other than deeds. The guidance expressly indicates that this route could be used for signing guarantees that are not executed as deeds.

The steps involved in signing using the second option are similar to those required in the first option, in that the signatory is only required to print and sign the signature page to the agreed form document sent to it by email. Where the procedures differ is that under the second option, the signatory's email back to the relevant law firm only attaches the scanned copy of the signed signature page (as opposed to attaching both the scanned signature page and the agreed form of the document under the first option) and the signatory must give authority to the recipient to attach the scanned signature page to the agreed form of the document.

The third option

The third option is designed for situations where the signature page may be signed before the final form of the document is agreed. The guidance makes it clear that this method is not to be used for signing deeds and real estate contracts, but does envisage the potential for guarantees (that are not executed as deeds) being signed in this way.

In this scenario, the signature page to the document under negotiation is sent to the absent signatory who prints it, signs it and emails a scanned copy of it back to the relevant law firm, to be held to the order of the signatory until authority is given for it to be attached to the relevant document. Once the form of the document

is agreed, it is sent to the signatory who responds with confirmation that it has agreed the final form of the document and authorises the relevant law firm to attach the pre-signed signature page and to date and release the document.

Choosing a route

The method used to effect a virtual signing or closing will clearly depend on the types of document being signed.

It is worth noting that although the guidance suggests that any of the three options could be used for guarantees that are not required to be executed as deeds, some practitioners, including Linklaters LLP, believe that it is sensible to use only option one for such guarantees. This is to avoid the risk that the guarantee may not be effective by virtue of not meeting the requirements for signature under the Statute of Frauds 1677.

Encouraging a consistent approach

The guidance does not (and was not intended to) cover all situations nor be a prescriptive roadmap as to how virtual signings should be organised. Different approaches to the signing and closing process will continue to be taken. However, the guidance is valuable because by addressing the principal areas of concern which have arisen in the light of the *Mercury Tax* decision, it can achieve its aim of encouraging a more uniform approach to virtual signings and closings.

Kirsty Thomson and Andrew Stanfield, London

Waving goodbye to your rights

A recent Court of Appeal case serves as a useful reminder of the importance for a lender or agent, when it is aware of a default, to send a reservation of rights letter to the borrower(s) as soon as possible following default. If it does not do so and continues to perform the contract and not accelerate/enforce, the lender may lose its termination right for that particular default. Lenders should not rely solely on "no waiver" clauses in facility agreements to avoid this result.

Tele2 case - the facts

The case of *Tele2 International Card Company SA and others v. Post Office Ltd.* [2009] All ER(D) 144 (Jan) concerned a supply contract entered into by the Post Office and Tele2. The contract included a remedies and waivers clause equivalent to that found in many loan agreements, providing that no delays in exercising rights following a breach would prevent the innocent party from exercising their rights at a later date.

Tele2 breached the contract and did not remedy that breach, but it was not until nearly a year after the breach that the Post Office tried to exercise its rights to terminate the contract. The Post Office was aware of the breach but continued to perform the contract during that year and did not contact Tele2 regarding the breach or to reserve its rights to terminate at a later date. The Post Office argued that the remedies and waivers clause in its contract meant that only a formal waiver of their rights could operate to prevent it from terminating the contract.

The Court of Appeal considered the following questions:

- whether the Post Office's delay in exercising its right to terminate the contract with Tele2 until just under a year after Tele2's breach giving rise to the right had taken place could amount to an affirmation of the agreement by election, resulting in the Post Office losing its right to terminate for that breach; and

- if so, whether the waiver clause in the contract preserved the Post Office's right to terminate despite affirmation of the breach.

Tele2 case - the decision

The Court of Appeal decided that the delay by the Post Office in terminating the contract, after becoming aware of the breach, and its continued performance of the contract without "any protest or reserve of any kind" in relation to the default was consistent with an election to abandon the right to terminate for that breach. This constituted a "clear and unequivocal communication, by conduct," of the Post Office's election to affirm the contract and abandon its right to terminate it.

The Court of Appeal also decided that the waiver clause in the contract, worded similarly to such clauses in market-standard financing agreements in providing that no delay or forbearance in exercising any right operates as a waiver or prejudices any right of that party under the agreement, did not preserve the Post Office's rights which it had lost as a result of its affirmation. The Court of Appeal found that such a general "remedies and waivers" clause is of no particular assistance to the relevant party, except perhaps in terms of emphasising the requirement that an election to abandon a right will only be shown if there is a clear and unequivocal communication of an election to do so and continue the contract. In this instance, it found that there had been such a communication, as discussed above.

Practical impact - reservation of rights letter

In practical terms, this means that such a waiver clause should not be relied on in isolation and a reservation of rights letter should be sent once a lender or the agent is aware of an event of default. The lender or agent should ensure that if it continues to negotiate with the borrower, perform the agreement and not accelerate, it makes clear that its delay in exercising its right does not constitute a waiver or affirmation of the breach/default. Such communication both upon the default and subsequently on an ongoing basis should, provided the lender's or agent's conduct is not inconsistent with it, mean that the lender's or agent's action in not terminating is not construed as an election to affirm the breach.

Practical impact - conduct of lenders

Lenders should therefore also consider carefully whether their conduct constitutes an election to affirm the loan agreement, thereby overriding the reservation of rights letter and communicating that, by their conduct, they are abandoning their rights as a result of the default. Whilst some scenarios are unlikely to constitute such conduct, in other situations the position may be less clear-cut. For example, a lender's continuing receipt of interest payments is not likely to constitute such conduct. Conversely, making new loans may in fact constitute action communicating abandonment of the lender's rights. It may appear to

run counter to the reservation of rights letter, and the lender or agent would be well advised at a minimum to require explicit acknowledgement from the borrower that the lenders' permission to allow the new drawdown does not constitute an abandonment of their rights.

Learning a lesson

The important lesson to take away from the *Tele2* decision is that lenders should not rely solely on the remedies and waivers language in their loan agreements to protect their rights following a default or event of default.

In order to mitigate the risk that their conduct during the period following a default when they are looking at their options results in an unintentional loss of the rights otherwise available to them under the loan agreement, it is important that lenders also ensure they take the time to reserve their rights expressly.

This should not only be done when the lenders first learn of the breach in a reservation of rights letter. Subsequent communications with the borrower during the period while the lenders are considering whether to waive the default or to take action should also include reservation of rights language, and the lenders should carefully consider their conduct during this period and the extent of the risk it poses to undermining, or even negating, their stated reservation of rights.

Lenders should be careful not to abandon their rights arising from a default through their conduct.

Kirsty Thomson, London

Real estate investment funds in Italy

Key features of Italian real estate investment funds

Real estate investment funds are investment funds that invest either exclusively or primarily in real estate assets, real estate rights (*diritti reali immobiliari*) and participations in real estate companies. These funds were introduced in Italy by a combination of the provisions of the consolidated financial act (Legislative Decree 58/1998) and subsequently by several ministerial decrees.

Real estate investment funds are regulated by the Bank of Italy which, among other things, has to approve the establishment of the fund as well as the management rules of the fund and any later amendments to those rules.

An investment fund is not a legal entity under Italian law, but instead amounts to an independent pool of assets which are represented by units belonging to investors in the fund. The assets are managed on a collective basis by an asset management company (*società di gestione del risparmio* "**SGR**") and each pool of assets is legally segregated from each other pool of assets managed by the SGR, from the assets of the SGR itself and from the assets of the investors that hold the units in the fund.

Since a real estate investment fund does not qualify as a legal entity under Italian law, Italian solvency laws do not apply. That means that it is not possible for a fund to be declared bankrupt. It is worth noting that the SGR which manages the fund can be subject to insolvency proceedings, though the SGR can be replaced if this happens.

An additional feature of many Italian real estate investment funds is that they are restricted from incurring financial indebtedness in excess of 60 per cent. of the open market value of their assets, which is tested periodically. This restriction does not apply to a fund which qualifies as a speculative fund.

"Restructuring a real estate investment fund does have some advantages compared with restructuring a corporate entity."

Tax treatment

Real estate investment funds enjoy a favourable tax regime in Italy, although limits on the tax benefits associated with them were recently introduced by the new budget law for 2009. The rules apply to lower value real estate funds with limited numbers of investors and include changes such as the reintroduction of a 1 per cent. property tax on the net value of the fund and an increase in the rate of withholding tax applicable to proceeds arising in connection with the fund units in certain circumstances from 12.5 per cent. to 20 per cent. The new rules will make closely held real estate funds less attractive to Italian investors.

Establishing Italian real estate investment funds

The real estate company would typically contribute a portfolio of real estate assets into the fund. There is a corresponding assumption by way of release (*accollo di debito liberatorio*) by the relevant fund of all or part of the debt allocated to the contributed properties, meaning that the fund assumes the debt allocated to those properties. The fund issues units which are initially subscribed for by the contributing company and which may subsequently be placed with institutional investors or, if regulatory clearance has been obtained, with the public.

A fund could purchase assets rather than have them contributed into it, but a sale and purchase of real estate assets attracts VAT at 20 per cent. of the value of those assets, whereas a contribution of assets which are "substantially leased" does not result in VAT being incurred. It is therefore normal for the assets to be contributed rather than purchased.

Real estate funds, which do not qualify as speculative funds, are restricted from incurring indebtedness in excess of 60 per cent. of the open market value of their assets. This means that they may only able to assume part of the debt that was originally incurred in relation to the contributed properties. Where this is the case, the real estate company that made the contribution will need to consider how to repay that debt. If the units the company received in exchange for the contribution of the properties to the fund have been placed with institutional or other investors, the company may use the proceeds of that placing to fund the repayment. Where the units have not been placed,

the company may instead refinance the debt with a new facility secured by a pledge over the units.

Key features of loan documents for real estate funds

Loan documentation entered into in relation to real estate investment funds typically includes a number of provisions tailored to reflect the nature of the fund and its management. In particular, it would be normal to see the following:

- representations and warranties as to the incorporation, existence and authorisations of the fund and the SGR;

- representations and warranties about the approval, validity and enforceability of the management rules of the fund;

- covenants requiring the delivery of the financial statements of the fund, restricting amendments to the management rules and locking in majority investors in the fund;

- a right for the lenders to appoint a new SGR upon the occurrence of certain trigger events; and

- specific events of default triggered by unauthorised amendments to the management rules, replacement of the SGR without permission, ineffectiveness of the fund documents and the insolvency of the SGR.

Loans made in respect of real estate investment assets may be secured by a pledge over the units issued by the fund, structured either as a pledge over receivables (*pegno su crediti*) or as a pledge over fund units (*pegno su quote del fondo*). The potential for this form of security to have adverse tax consequences, primarily for the borrower, means that lenders sometimes agree to forgo this element of their security package on the basis that the benefit of the security is disproportionate to the consequences for the borrower of taking it.

Restructuring real estate investment funds

The real estate market has been particularly hard hit by the global economic downturn. In some cases the average market value of real estate portfolios in Italy has decreased 30-35 per cent.

In common with many other sectors, real estate borrowers are struggling to meet their financial covenants. Those borrowers are unable to liquidate their portfolios because depressed asset prices have made it difficult for them to achieve the minimum sale prices required by their loan documents for them to be able to freely dispose of assets in their portfolios. Refinancing existing indebtedness is similarly a considerable challenge.

There has consequently been a marked increase in waiver requests and, in more serious cases, a need for a general restructuring of the financing arrangements that underpin these real estate portfolios.

Restructuring a real estate investment fund does have some advantages compared with restructuring a corporate entity. As far as fund managers are concerned, the fact that Italian solvency laws do not apply to real estate funds means that they have a greater degree of freedom when negotiating restructuring terms and a reduced risk of personal liability that could otherwise arise in an insolvency. From a lender's perspective, the segregation of fund assets allows a greater degree of control over those assets on an enforcement if terms are not agreed.

The real challenge that the market faces over the coming year is in understanding how regulators will react to restructurings of real estate funds.

Andrea Arosio, Davide Mencacci and Valerio Fontanesi, Milan

Recent changes to the Spanish insolvency regime

The declining health of the Spanish economy has prompted a series of urgent measures to be issued in relation to tax, finance and insolvency proceedings in Spanish law. The Spanish statute relating to insolvency proceedings, Spanish Act 22/2003 (the "**Insolvency Act**"), was amended by a Royal Decree Act (the "**RD Act 3/2009**") ratified by a resolution of the Spanish Parliament on 29 April 2009.

One of the main aims of this amendment, which came into force on 1 April 2009, is to improve certainty in the context of refinancing companies in distress in order to avoid such entities being obliged to file for insolvency. The amendment has attracted some criticism. In particular, there have been concerns that the amendment does not address a number of issues associated with the Insolvency Act introduced in 2004 and that it was made without going through a prior consultation process. There have also been questions as to how certain aspects of the amendment will work in practice.

Nonetheless, credit institutions have generally welcomed the new provisions. They have created a new framework in which refinancings may take place and have clarified a number of legal queries that arose as a result of the original wording of the Insolvency Act. We set out below a brief analysis of the new regime for distressed corporate refinancings, recent experience in the market since the amendment came into force and an explanation of some other key changes that were made by RD Act 3/2009.

Refinancing Agreements: Safe harbour

The backlog and response time of the Spanish courts combined with concerns over certain risks created by the original wording of the Insolvency Act from 2004 has led companies and financial creditors to endeavour to avoid formal insolvency proceedings when considering restructurings in recent years. The view was that out of court agreements were a much more effective instrument when working to preserve a company's value.

An area of Spanish insolvency law that had previously raised concerns has been clarified.

The risks that arise from the original Insolvency Act stem from a rebuttable presumption that any security granted within the period of two years up to insolvency is prejudicial to the estate of the insolvent entity and could be challenged and declared invalid. The intention of the parties at the time the security was granted is irrelevant. That presumption created significant uncertainty among credit institutions in the context of refinancing transactions, particularly as market conditions deteriorated. In some cases, the Commercial Courts have gone so far as to view the insolvency of a company that granted security as proof that the security was prejudicial to it. This prompted RD Act 3/2009 to create a "safe harbour" for certain refinancing agreements.

How the safe harbour works

The safe harbour works by establishing privileged proceedings in which the ability to challenge the refinancing agreements is substantially restricted, provided that those agreements are not fraudulent. The idea is that this should encourage the refinancing companies in financial difficulties and enable them to operate as a going concern. The conditions that must be met in order to establish these proceedings are:

- the refinancing must mean a "significant increase" in the funds available to the borrower or a modification of the terms of the initial financing (through an extension of the maturity date or replacing the existing obligations with new ones);

- the refinancing agreement must be agreed as a result of a viability plan intended to ensure the solvency of the debtor in the short and medium term. The plan must be supported by a report from an independent expert, which considers, among other things, whether the plan is reasonable and achievable and whether the granting of new security as part of the refinancing could be considered to be proportionate taking into account market conditions at the time the security is to be granted;

- the refinancing must be backed by creditors holding at least 60 per cent. of the claims against the debtor at the time the refinancing agreement is executed; and

- the refinancing and other related and supporting documents must be set out in a public deed.

The privileged proceedings are applicable not only to refinancing agreements concluded after the enactment of RD Act 3/2009, but also to any concluded prior to

1 April 2009 provided that no petition of insolvency in relation to the relevant company had been filed at such date and the requirements set out above have otherwise been met. However, there are still some concerns around how the conditions that need to be met as part of the safe harbour regime created by RD Act 3/2009 will work in practice.

What is a "significant increase"?

The wording of RD Act 3/2009 dealing with the first condition above provides that refinancing agreements are "*those creating a significant increase of the funds available to the borrower, or a modification of the terms by extending the maturity date or by entering into new obligations*". It is worth noting that the new procedure is very flexible when compared to the initial drafts of the new law, which required the refinancing to provide creditors with at least 20 per cent. of additional funding.

The new law provides for an alternative to the "significant increase" in funds in the form of a modification to the terms. Interestingly, the wording of the condition only uses the word "significant" in the context of an increase to the facilities, so it is thought that a modification to the terms does not necessarily need to be "significant". A modification to the terms of the financing agreements will suffice. That modification may be made either by extending the maturity date or by entering into new obligations that replace existing obligations (which may be related to the guarantees, interest rates, financial covenants and so on).

The core requirement seems to be that any such modifications enable the company to continue as a going concern in the short and medium term.

The independent expert

The RD Act 3/2009 does not explain who may be considered an independent expert nor what conditions that expert must meet. However, it is certain that the auditor of the company that is the subject of the refinancing cannot act as the independent expert. It is also clear that the independent expert cannot be appointed as receiver (*administrador concursal*) if the company is declared insolvent.

The role of the independent expert is fundamental to meeting the conditions of RD Act 3/2009. If the opinion of the independent expert does not support the viability plan, the refinancing agreement would not benefit from the exemption from challenge (*acción rescisoria*).

It is not clear whether the opinion of the independent expert is only expected to support (or object to) the reasonableness and achievability of the business plan or whether it may also express reasoned or qualified opinions. In the latter case, there could be a risk that such a report does not give the parties sufficient comfort that they have met the requirements of the RD Act 3/2009. On a related note, the new law does not clarify what potential liability is incurred by independent experts when issuing these reports.

The RD Act 3/2009 is not prescriptive as to when the independent expert is to be appointed by the Commercial Registry and, for now at least, Registrars in different locations are adopting different approaches as to whether the appointment is made before the refinancing agreement is terminated, during the negotiations between creditors and debtors, or once the final draft of the refinancing agreement has been agreed. The difficulty with the third option is that if the independent expert does not approve a viability plan produced after long negotiations, it could halt the rescue process - clearly a disincentive to seeking this type of solution.

Creditors' approval

The approval of at least 60 per cent. of the creditors may well be relatively easy to meet in relation to special purpose vehicles that have incurred significant debt, for example to finance an acquisition. However, in the case of a corporation with a number of different groups of creditors, such a threshold might be harder to achieve. As a result, any stand-alone refinancing of bilateral facilities would be likely to fall outside the scope of this new provision.

In any event, the new wording of the law seems to require only that 60 per cent. of the creditors approve the refinancing agreement, but not that such arrangement affects 60 per cent. of the total debts. In other words, creditors representing 60 per cent. of the debts could approve a refinancing agreement relating to a lesser portion of debts.

Creditors' arrangements

RD Act 3/2009 includes several measures aimed at facilitating creditors' arrangements. Prohibitions established in previous legislation on the implementation of an advance proposal for a

creditors' arrangement (*propuesta anticipada de convenio*) resulted in such arrangements being non-existent in practice. The recent amendment, however, seeks to encourage advance proposals for creditors' arrangements through the following changes to the regime:

- **Greater flexibility for filing an advance proposal for a creditors' arrangement**: The filing of this kind of proposal after 1 April 2009 is subject to fewer conditions. The conditions arise where there is a conviction for certain crimes in a non-appealable judgment or where the requirement on the company to file financial statements was breached in the three tax years preceding the insolvency petition.

- **Submission of advance proposals at the time of filing of the petition for insolvency**: Where the advance proposal is submitted at the time of filing of the petition for insolvency, it will be duly processed if it is supported by creditors representing up to 10 per cent. of the total debt of the relevant entity at the time of filing the petition for insolvency. In contrast, if the proposal is submitted at a later stage of the insolvency proceedings, the required threshold is 20 per cent. of the creditors at the time such proposal is submitted. The participation of subordinated creditors as well as privileged, including secured, and ordinary creditors will also be taken into account to determine the minimum threshold to submit an advance proposal.

- **Extension of the time limit to comply with the current insolvent debtor's (*deudor en situación de insolvencia actual*) duty to file for insolvency**: Debtors who, within the two-month period in which they are obliged to notify the judge of their actual insolvency, confirm that they are in negotiations with creditors to seek support for an advance proposal are, in practice, granted a four-month grace period prior to being required to file for insolvency. During such period, other potential insolvency requests filed by other creditors with respect to the same debtor are not taken into account.

Conclusion

RD Act 3/2009 clarifies an area of law that had previously raised significant concerns among companies and financial institutions. The conditions to be met for the privileged status of refinancing agreements were not drafted in a prescriptive manner, so that there is an element of flexibility associated with meeting them on a case by case basis. The other side of the coin is that the drafting poses a number of practical issues that will need to be clarified by the Registrars and the courts.

Within a few days of the enactment of RD Act 3/2009, the Government announced a plan for broader amendments to be made to the Insolvency Act. According to the Government, these future amendments will cover conditions for voluntary or obligatory filing for insolvency, status of employees during insolvency proceedings and special measures to deal with excessive indebtedness of consumers. Although the enactment process may still be some way off, the proposed new bill should ultimately achieve a more considered response to the current market environment.

Pedro de Rojas and Jaime Zurita Carrión, Madrid

The power of appropriation

Alfa Telecom Turkey Limited v Cukurova Finance International Limited [2009] UKPC 19 is the first case to analyse how a mortgagee can enforce its security by appropriating the relevant collateral. Appropriation is an additional enforcement remedy introduced by the Financial Collateral Arrangements (No.2) Regulations 2003 (the "**Regulations**") with effect from 26 December 2003. The Regulations implemented the EU Directive on Financial Collateral Arrangements (the "**Directive**") in the UK. The purpose of the Directive was to provide a fast, effective and uniform means of enforcing security over shares and other financial instruments. This article considers the key points arising out of the Privy Council decision in *Alfa Telecom*.

Overview of the Regulations

The Regulations apply to "financial collateral arrangements" ("**FCAs**"). This term covers both title transfers, where title is transferred as security for an obligation on terms that it will revert back to the original owner when the secured obligation is discharged and also other security arrangements involving financial collateral where the security holder does not become the legal owner of the secured asset. Financial collateral means cash or financial instruments, which broadly include equities, bonds and other specific instruments. In summary, most security interests over, or outright transfers of, financial instruments or cash, to secure or otherwise provide collateral for a financial obligation, will be covered by the Regulations.

The Regulations modify certain formalities required to create and perfect FCAs, modify insolvency law in relation to the enforcement of FCAs and introduce certain rights, such as the rights to use and appropriate collateral, in relation to FCAs.

This is the first case to analyse how a mortgagee can enforce its security by appropriation.

The power to appropriate

Regulation 17 provides that "where a legal or equitable mortgage is the security interest created or arising under a security financial collateral arrangement on terms that include a power for the collateral-taker to appropriate the collateral, the collateral-taker may exercise that power in accordance with the terms of the security financial collateral arrangement, without any order for foreclosure from the courts".

Therefore, where a collateral-taker under a security FCA has a legal or equitable mortgage over the collateral, it might, as a self-help remedy, enforce any right of appropriation of the collateral. This power to appropriate is only available if the parties have agreed it in the security FCA.

The Regulations do not define the meaning of "appropriate", nor do they prescribe formalities or guidelines for the exercise of the remedy of appropriation. The only detail relating to the power of appropriation, set out in Regulation 18, is the duty to value the collateral and account for any differences in value on appropriation. This requires the collateral-provider to account to the collateral-taker for the amount by which the value of the collateral is less than the amount of the debt, while if the value of the collateral exceeds the amount of the debt, the collateral-taker must account to the collateral-provider for the difference.

The issue of whether an equitable mortgagee can appropriate without being the registered owner of the shares and how to effect a valid appropriation came before the Privy Council, on appeal from the Eastern Caribbean Appeal Court in *Alfa Telecom*.

Alfa Telecom core facts

The key issue on appeal in *Alfa Telecom* was whether Alfa, as mortgagee, had effectively exercised the remedy of appropriation in relation to shares in two British Virgin Islands ("**BVI**") companies under English law governed share mortgages. The share mortgages were equitable mortgages granted by Cukurova Finance International Limited and its parent, Cukurova Holding AS, to secure a loan of US$1.352 billion made available by Alfa to Cukurova Finance. Alfa had never been registered as the shareholder of the mortgaged shares in the relevant company registers.

Following a default by Cukurova Finance under the loan, Alfa purported to appropriate the shares in the two BVI companies by sending letters to the

registered offices of the mortgagors declaring that it was exercising its right to appropriate without having become the registered owner of the shares. Alfa presented the share certificates and transfer forms for the mortgaged shares to the companies that issued the shares.

High Court and Court of Appeal decisions

The judge at first instance in *Alfa Telecom* held that there must be "some overt, unequivocal action by a lender which has the effect of both destroying the equity of redemption and of vesting the legal and equitable rights in him for the right of appropriation to be exercised". This meant that the letters sent by Alfa were ineffective to appropriate the shares. An equitable mortgagee must first become the absolute owner by obtaining legal title to the shares in order to exercise the remedy. Under BVI law a person is not recognised as the legal owner of the shares until they are registered in the share register and so registration of the transfer was required in order to appropriate.

The rationale for this decision seems to have been as follows. First, the concept of appropriation must be given an autonomous meaning that can be applied uniformly to all Member States and not a meaning that makes sense only by reference to the English concepts of equitable ownership and the equity of redemption (because these concepts are not recognised in the civil law countries of the EU). Secondly, registration was required to lend certainty to the process of enforcement by appropriation and because it would be commercially unacceptable for a lender to be able to appropriate simply by determining to do so.

The Court of Appeal overturned the decision at first instance. It decided that, under an equitable mortgage, forming an intention to appropriate the shares (evidenced by the letters sent to the mortgagors) was sufficient to exercise the remedy. Influential in this decision was the fact that the Regulations expressly provide that appropriation is available to equitable mortgagees as well as legal mortgagees as a self-help enforcement remedy which requires no court order or other formality for its exercise. It would, therefore, be contrary to the express intention of the Regulations to interpret appropriation in a way that makes an equitable mortgagee's ability to appropriate contingent on the company's registrar registering the transfer of shares, and so effectively meaning that an equitable mortgagee can never appropriate unilaterally. The Court of Appeal saw no difficulty in interpreting the language of the Directive to accommodate this English legal concept.

Interestingly, in his expert evidence, Lord Millett stated that the deposit of the share certificates and executed stock transfer forms implies a contract to transfer the shares, which, being specifically enforceable, passes an equitable interest, and such interest being by way of security only, creates an equitable mortgage. If correct, then such an analysis means that an equitable charge which provides for the deposit with the chargee of the share certificates and blank executed transfers (which are market standard requirements in most share security documentation), should instead be characterised, for the purposes of the Regulations at least, as an equitable mortgage. In such circumstances, an equitable "chargee" could have the power to appropriate provided that the parties agree that in the relevant agreement.

The Court of Appeal also confirmed that in the same way that foreclosure is available to an equitable mortgagee, who is not required to obtain legal title before foreclosing, an equitable mortgagee is not required to acquire the legal title to the mortgaged shares in order to appropriate. It was sufficient for the equitable mortgagee to form the intention to appropriate the collateral. In this case, the forming of that intention, together with notification of appropriation to the mortgagors, meant that the equitable mortgagee became the absolute beneficial owner of the equitable title to the shares (the equity of redemption being extinguished) and the mortgagors were left holding the legal title as bare trustee.

Privy Council Decision

Meaning of Appropriation

The Privy Council noted in relation to shares in a company (and especially unquoted shares which cannot be easily valued) that the notion of appropriation by the unilateral act of the collateral-taker was a novel concept. As such, it would have been useful if the terms of Regulation 17 had been more expansive. Indeed, Lord Walker notes that "*the curiosity of this case is that the United Kingdom Treasury seems to have thought that appropriation was already a familiar remedy in the United Kingdom, so it was not necessary to define it or give any detailed guidance as to how a power of appropriation was exercised*". As regards the meaning of appropriation, the Privy Council made clear that it is, in effect, a means of "making property one's own". While appropriation is often compared to foreclosure, the Privy Council seem to find it closer to a sale than to foreclosure, being in effect a sale by the collateral-taker to himself, at a price determined by an agreed valuation process.

The requirements for a valid appropriation

Allegra Miles, London

Turning to the essential issue of whether an equitable mortgagee could validly exercise the power to appropriate without first being registered as the legal owner in the share register of the companies whose shares were mortgaged, the Privy Council agreed with the reasoning of the Court of Appeal that entry in the share register was not a condition precedent to the exercise of the remedy of appropriation. Any other interpretation of the Regulations would mean that the collateral-taker did not have the means of speedy, non-judicial enforcement as required by the Directive. In this regard, they noted that where the registrar of the entity whose shares are mortgaged has no difficulties about registration, it would be easy for the collateral-taker in most cases to become the registered owner either just before or soon after exercising its power of appropriation.

However, while agreeing with the Court of Appeal on this essential point, the Privy Council disagreed with the view that the collateral-taker can exercise a power of appropriation without any overt act at all. On the basis of commercial practicalities, the Privy Council was of the view that there should be an overt act announcing the intention to exercise a power of appropriation, communicated to the collateral-provider. In this case, Alfa's letter was that communication.

One issue that the Privy Council did not need to decide in their judgment was whether equitable charges are covered by Regulation 17 as Lord Millet indicated. Until the point is clarified by judicial authority, the safer option for secured lenders wishing to ensure the power to appropriate under the Regulations is to use an equitable or legal mortgage.

In the meantime, the Privy Council decision provides welcome clarification for security holders on the practicalities of enforcing security over financial collateral by appropriation where the Regulations apply. It confirms that appropriation is both a powerful and flexible tool for holders of both legal and equitable mortgages within the scope of the Regulations.

Buyback mountain: loan repurchases under New York law credit agreements

Introduction

In the current market where the prices of even well-performing loans can be significantly below par, there are incentives for borrowers and sponsors to repurchase loans in the secondary market. Although loan repurchases may be appealing – both to sponsors (who see it as a chance to increase their returns, either by deleveraging their acquired companies or by holding the loans for investment) and to lenders (who appreciate the liquidity in an otherwise frozen market) – they also raise many legal issues.

In determining whether and the terms on which to allow loan repurchases, every transaction must be analysed individually given the lack of uniformity amongst New York law credit agreements. There are a number of provisions in most New York law credit agreements that must be reviewed in order to determine the viability of, conditions to, and best means of effecting, repurchases, including those relating to (1) transfers, (2) pro rata sharing, (3) prepayments (including the provisions pertaining to the application of proceeds), (4) affirmative and negative covenants and (5) amendment.

In addition, the parties must agree on the terms and conditions on which such repurchases will be permitted. Such terms and conditions often require: (1) that repurchases (and any tax payments triggered thereby) be funded using only the cash proceeds of new equity contributions or issuances, (2) that the relevant loans be cancelled immediately following the repurchase, (3) that the loan documentation be amended to neutralise the impact of repurchases on financial covenant compliance, "excess cash flow" calculations and prepayments, as well as scheduled repayments or mandatory prepayments, (4) limits on the number of offers, the time period during which offers may be made and the aggregate amount of loans that may be repurchased, and (5) that all repurchase offers be open to all lenders, pro rata, at an agreed price for all lenders or by Dutch auction conducted by the administrative agent (using offer mechanics agreed in advance or subject to the administrative agent's discretion). In addition, to the extent there are other layers of debt – such as second lien debt or subordinated debt – which may be subject to repurchase, the interaction of offers for senior loan repurchases with such other offers, as well as the intercreditor implications, need to be considered.

Restrictions on loan repurchases in New York law credit documentation

Prior to 2008, neither borrowers nor lenders contemplated that loan repurchases at substantially less than par value would become possible and allowing sponsors or their affiliated entities to invest in loans was not an established concept. Consequently, there are a number of ways in which New York law credit documentation may restrict loan repurchases or any other holding of loans by sponsors and affiliates. If the parties to an existing credit agreement wish to permit such repurchases, they will need to consider (i) what amendments to such documentation are needed and (ii) what consents will be required to approve such amendments.

Assignment provisions

Most New York law credit agreements include a concept of "eligible assignees" (or a variation thereof), who are the only persons to whom loans may be assigned. In most cases, the definition includes banks and other financial institutions, but it very commonly excludes the sponsor, the loan parties and their respective affiliates. If this is the case, then such definition will need to be amended to permit loans to be transferred to such of the sponsor, the loan parties and their respective affiliates as the parties may agree. Additionally, it is important to review the assignment provisions in the credit agreement, as these may need to be amended. For example, assignment provisions typically contemplate that the assignee will become a lender. If the repurchased debt is to be extinguished, amendments to the assignment provisions may be required.

Pro rata sharing provisions

Most credit agreements include provisions that ensure that no lender of a particular class will receive a share of any repayment or prepayment of loans that is disproportionate to its share of the funded loans of such class. The drafting of such provisions varies from one credit agreement to another, but typically these provisions apply to repayments or prepayments of principal and payments of interest and other amounts owing under the credit documents. Most New York law credit agreements contain a general "catch-all" rateable sharing provision, as well as specific pro rata terms that apply to voluntary, scheduled, mandatory and other payments. All such provisions need to be

examined to determine if they would apply to the buyback transaction being considered. If any of the pro rata sharing provisions would apply to a loan repurchase, the selling lender might be required to share the sale proceeds with the other lenders. Accordingly, there would be little incentive for lenders to sell their loans to the sponsor, the loan parties and/or their respective affiliates if such repurchases were not excluded from the pro rata sharing provisions.

There is some debate as to whether a loan repurchase should be viewed as a de facto prepayment and therefore subject to pro rata sharing. The intention of pro rata sharing is to make certain that lenders are treated equally with regard to payments under the credit agreement rather than to guarantee equality in all circumstances. Pro rata sharing does not apply to lender recoveries from the sale or trading of loans or from derivative or other credit protection. When the buyer of the loans is obligated to repay those same loans, the key question is whether that particular transaction is in substance a "repayment". The language of the relevant credit agreement, the identity of the purchaser and the treatment of the repurchased loans may affect the determination. For example, a purchase of a loan by the borrower and the retirement of the loan so repurchased would appear more like a prepayment than would a purchase by a sponsor where the loan is held to maturity. Some credit agreements explicitly exclude assignments from the pro rata sharing mechanism, making it easy to structure loan repurchases in ways that are unlikely to be challenged under the pro rata sharing provisions. Where there is uncertainty, borrowers and lenders must consider carefully whether an amendment to the pro rata sharing provision is necessary or advisable before proceeding with loan repurchase transactions. This is an important issue as it is not uncommon for credit agreements to require the consent of all lenders (not simply the majority lenders) to amend the pro rata sharing provisions, which would likely make such an amendment impracticable.

Payment provisions

In addition to considering whether a loan repurchase could constitute a de facto prepayment for the purposes of the pro rata sharing provisions, it is also important to determine whether such a transaction would affect, or be affected by, other payment provisions in the credit agreement. One concern relates to mandatory prepayment provisions. In some credit agreements, the proceeds of any issuance or contribution of equity must be applied to prepay outstanding loans, whereas in others the proceeds of equity issued to or contributed by the sponsors (or other specified investors) are excluded from the mandatory prepayment requirements and therefore may be used by the loan parties to fund a loan repurchase. In the former case, an amendment will be required if the loan repurchase is expected (or required) to be funded with equity proceeds.

Another concern is the effect of the loan repurchase on scheduled payments or prepayments (for example, prepayments of "excess cash flow"). Many credit agreements do not permit reductions in the principal amount of any loan or in the scheduled repayments thereof without the consent of each affected lender in addition to the consent of the "Requisite Lenders" or "Required Lenders" (typically a simple majority of lenders). If repurchased loans are to be extinguished, then care must be taken to ensure that scheduled repayments owing to non-selling lenders are not reduced without the consent of such non-selling lenders.

Covenants

Because loan repurchases are not contemplated in most existing credit agreements, it may be necessary to amend the covenants and related definitions. For example, additional carve-outs and/or add-backs may need to be included to ensure that such repurchases do not inappropriately affect financial covenant compliance (for example, by inflating EBITDA and thereby understating leverage ratios or overstating interest or fixed charge coverage ratios). If a loan repurchase by a loan party is to be funded using the proceeds of an equity issuance or contribution, it is important to ensure that the covenants allow such loan party to both purchase loans and issue new equity.

Some borrowers may request from lenders prospective "catch-all" waivers of any inadvertent technical defaults resulting from a permitted loan repurchase. In transactions where such waivers can be granted by the majority lenders, this request may give borrowers and future selling lenders comfort that their repurchases will be less likely to be challenged. However, it is not market practice to grant prospective waivers, which would transfer the risk of a default from

Loan repurchases may be appealing to sponsors and to lenders, but they raise many legal issues.

the borrower to the lenders. Accordingly, some lenders may object to such a broad waiver as too vague and likely to adversely restrict legitimate rights against the borrower if a loan repurchase were to have unintended adverse consequences. For instance, if the repurchase breaches a covenant in another debt instrument, the lenders should not be waiving cross default rights arising from that breach by reason of having granted a catch-all waiver. In most cases, a carefully drafted amendment should make a broad waiver unnecessary.

Structuring loan repurchases

Loan repurchases are often being permitted on fairly restrictive terms, as borrowers and lenders are trying to ensure that these transactions are fair to all parties (including non-selling lenders) and thus less likely to be subject to subsequent challenge. A major goal of most loan repurchases is to enhance the credit profile of the loan parties (or at least not to impair it).

Equity funding for repurchases

Loan repurchase-related amendments to credit agreements often require that loan repurchases be funded solely with proceeds of new equity issuances or contributions. The loan parties typically are not allowed to use cash on hand, proceeds of loan or other debt facilities or proceeds of asset dispositions (especially if the relevant assets are collateral securing the loans) as doing so will not improve – and may impair – the credit profile of the loan parties or otherwise reduce the common pool of assets and credit available to service all the loans.

The new equity funding condition may require that additional equity be contributed if a loan repurchase will result in higher tax payments for the loan parties (particularly on account of income recognised upon the cancellation of debt ("**COD Income**")). In the case of a multi-jurisdictional credit facility, the inclusion of a tax gross-up should be evaluated, notwithstanding the recently-enacted U.S. economic stimulus legislation (which mitigates the tax effects of COD Income on most U.S. corporate borrowers), because non-U.S. jurisdictions may continue to require recognition of income upon the cancellation of debt or impose other taxes.

Extinguishment of repurchased loans

Sponsors sometimes request that repurchased loans be allowed to remain outstanding at the option of the purchaser (for example where a sponsor wishes to hold the loan as an investment), with the purchaser becoming a lender for purposes of the credit agreement. If this is acceptable to lenders (it often is not), lenders would typically require that the voting rights of such holder be restricted and that the loans so held be excluded when making determinations of "required lenders" or other majority lender calculations, so that the borrower and its affiliates cannot manipulate voting in relation to future requests for amendments, consents and waivers. It is not clear whether a waiver of voting rights would be enforced with respect to the sponsor's rights as a secured creditor in a bankruptcy proceeding. Some buyback structures have also attempted to neutralise the impact of the loans held by affiliates of the borrower by deeming the loans not outstanding for any purpose (including pro rata payments) or by subordinating loans so held to the loans held by other lenders. The benefit of these structures to the borrower and the lenders is clearly not the same as cancelling the debt and for legal and accounting purposes the debt is still an obligation of the borrower. Accordingly, many lenders require that any loans purchased by a sponsor, a loan party or an affiliate thereof be cancelled immediately upon consummation of the purchase.

Neutralisation of impact on financial covenants, excess cash flow and payments

The lenders are likely to require the inclusion in the relevant amendment agreement of provisions modifying the financial covenant definitions, the provisions relating to scheduled repayments and mandatory prepayments and any similar or related definitions and provisions, such that neither new equity funding nor loan repurchases would have any adverse effect on these provisions. Loan repurchases should not allow loan parties to circumvent the originally agreed financial covenants via manipulation (whether or not intentionally) of accounting definitions or financial calculations or to loosen any triggers relating thereto (such as covenant carve-outs subject to maximum leverage ratios or minimum coverage ratios).

As noted above, if the loan documents provide that equity contributions must be applied in mandatory prepayment of the outstanding loans, an exception will need to be made for equity used solely for loan repurchases. Also, unless the amortisation schedule is amended to account for the loan repurchases, the borrower may need to make the same scheduled repayments (when expressed in absolute rather than percentage terms) as it would have done absent such repurchases, even if this results in the remaining lenders receiving larger payment instalments.

Further, annual excess cash flow sweep prepayment calculations are typically reduced by prepayments of loans made during the course of the applicable year, so as to not "over-sweep" the borrower's cash. Whether the repurchase amount should likewise reduce such calculation or be expressly excluded from consideration can be the subject of negotiation, depending on the flexibility in the document to amend the calculation of that prepayment. This is more of an issue when the borrower is using its own cash (and not proceeds of new equity) to effect the repurchase.

Limitation on number and amount of repurchases and repurchase period

Loans documented on market standard terms are not treated as "securities" under U.S. federal securities law. As such, loan repurchases, unlike repurchases of corporate bonds or other debt securities, are not subject to a disclosure regime that would prevent purchasers from taking advantage of inside information to profit at the expense of selling lenders (for instance, by repurchasing loans below par in contemplation of a contemplated, but undisclosed, change of control that would otherwise require repayment of the loans at or above par). In most instances, lenders have not conditioned loan repurchases on receiving a representation from the purchaser that there is no material information that has not been disclosed to the lenders, but nor are they waiving any legal or equitable claims that might arise from any nondisclosure. Additionally, lenders may seek to reduce their exposure to such an information imbalance by limiting the number of loan repurchase offers, the time period in which they may be made (often to 12-18 months) and the total amount of debt that may be repurchased through such offers. While this is not a perfect solution, it gives the lenders some comfort that the borrower's situation is less likely to change in a way that favours the purchaser, and if such a change occurs its effects will be limited.

Extension of loan repurchase offers to all Lenders on a pro rata basis, at a single price or by modified Dutch auction, and managed by the Agent

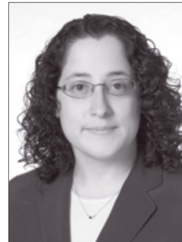
Because loan repurchases are conducted in the secondary market, some sponsors seek the freedom to negotiate loan repurchases with individual lenders. However, as these are not ordinary assignments, loan repurchases are best conducted by means of a tender offer to all lenders holding the applicable class of loans. As a condition to allowing repurchases, lenders require that all lenders be permitted to participate on a pro rata basis at the offered price (or range of prices, in the case of a Dutch auction, as described in the following paragraph) and on the same terms applicable to such price.

One of the key terms that must be determined with respect to each repurchase is the sale price to be applied to the repurchased loans. In some cases, the purchaser may offer to purchase loans at a specified price. Often, however, repurchases are conducted by means of a modified Dutch auction, whereby the purchaser specifies a range of prices at which it is willing to purchase loans, and each lender may specify the amount of loans and the price (within the range specified by the purchaser) at which it is willing to sell them. Based on the prices and amounts offered by the lenders, a sale price is determined, which is the lowest price offered by a lender at which the purchaser can complete the repurchase of the amount of loans it is seeking (or, if the lender responses are insufficient to allow the purchaser to complete the repurchases of such amount, the highest price specified by any lender that is within the range specified by the purchaser). Once the sale price has been determined, the purchaser repurchases all offered loans at such price (or, if the amount of offered loans exceeds the amount sought for purchase, the borrower purchases the offered loans rateably, based on the lenders' respective amounts tendered).

Given the complexity of the repurchase process (particularly where Dutch auctions are used), to ensure that the offer process is conducted fairly and is sufficiently transparent, the administrative agent ideally would oversee the process, managing all communications with lenders and being the arbiter of pricing and other determinations. Ideally, either the particular form or material terms and scope of the offer documents (particularly if a modified Dutch auction is desired) will be agreed in connection with the facilitating credit agreement amendment.

Conclusion

The ability to repurchase loans depends on the drafting of the applicable loan documents. The assignment, pro rata sharing and payment provisions, as well as the covenants, in the applicable credit agreement must be reviewed carefully to determine the amendments that will be required to (1) allow loan repurchases and (2) preserve the intended effects of financial covenants and repayment and prepayment provisions. Additionally, each loan repurchase should be structured so as not to impair the loan parties' credit profile or the lenders' expected returns. With careful structuring and drafting, borrowers can delever and selling lenders can reduce their exposures without adversely affecting the remaining lenders.



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