**Restructuring procedures**

This element covers formal restructuring options for companies in financial difficulties.

**Order of coverage of topic**

The topic of restructuring and insolvency is covered in the following order:

· Introduction to legislative framework;

· Pre-insolvency moratorium under CIGA 2020;

· Formal restructuring arrangements;

· Insolvency procedures; and

· Statutory order of payment of creditors.

These slides cover the topic of formal restructuring arrangements for companies in financial difficulties. The next set of slides cover insolvency procedures and the final set of slides cover the statutory order of priority for payment of creditors in an insolvency.

**Restructuring and insolvency: a background**

Corporate restructuring and insolvency law relates to companies that are in or facing distress. The underlying aim of corporate restructuring and insolvency law is to mitigate that distress and put the company on a sustainable footing so it can continue as a going concern, while protecting and balancing the interests of competing creditors to promote a culture where distressed businesses are rescued and can recover if possible. One of the reasons for this is that creditors are likely to recover more money if businesses can be rescued or restructured than if they are closed down and the assets sold off piecemeal.

The main relevant statute is the Insolvency Act 1986 (the ‘**IA 1986**’).

The IA 1986 has been substantially amended over the years by theInsolvency Act 2000, the Enterprise Act 2002 (‘**EA 2002**’), the Companies Act 2006 (‘**CA 2006**’), the Deregulation Act 2015, the Small Business Enterprise and Employment Act 2015 and the Corporate Insolvency and Governance Act 2020 (‘**CIGA 2020**’)

The IA 1986 is supplemented by the Insolvency (England and Wales) Rules 2016 (the '**IR**

The Companies Act 2006 (as amended, including by CIGA 2020) also contains key restructuring procedures.

**Summary of the EA 2002 reforms**

The EA 2002 came into force on 15 September 2003 (the ‘**Relevant Date**’).

The aims of the EA 2002 for companies were:

· to promote the rescue culture; and

· to increase entrepreneurship by giving prominence to *collective insolvency procedures* over *enforcement procedures.*

The focus of the EA 2002 was on streamlining the *administration* procedure to encourage company rescue and to restrict the use of *administrative receiverships* by holders of *qualifying floating charges*.

**Summary of the CIGA 2020 reforms**

CIGA 2020 introduced three new restructuring and insolvency tools:

(1) the **pre-insolvency moratorium**

(2) the new **restructuring plan** for companies

(3) restrictions on the enforcement in supply contracts of termination clauses (and other contractual rights) triggered by restructuring and insolvency processes.

These tools are intended to provide companies in or facing distress with a breathing space and security of supply so that they have time to explore enhanced restructuring options to maximise the prospects of rescue.

**Restrictions on insolvency related contractual terms**

CIGA has introduced restrictions on the enforceability of termination (and other) clauses in most types of supply of goods and services contracts. A supplier may not terminate or rely on a contractual provision allowing it to do any other thing on grounds that:

· the counterparty has obtained a pre-insolvency moratorium, or

· the counterparty has entered into administration, liquidation or administrative receivership, or

· the counterparty's creditors have approved a company voluntary arrangement (CVA), or

· the court has sanctioned a restructuring plan or a scheme of arrangement in relation to the counterparty.

There is also a prohibition on suppliers making it a condition of any future supply that pre-insolvency debts owed to them must be paid. The effect of this prohibition is that suppliers must continue making supplies under the terms of the contract notwithstanding the company has entered into one of the procedures listed provided that the company pays for any supplies made after the counterparty becomes subject to the relevant procedure.

The prohibitions referred to above do not:

· apply to loans and most other types of financial contracts,

· prevent termination of a contract on other grounds, for example if the counterparty commits a default after it becomes subject to a restructuring/insolvency procedure, or where the supplier is entitled to terminate the contract pursuant to a contractual clause allowing termination by the giving of a notice (e.g. a three months’ notice termination provision).

**Pre-insolvency Moratorium**

The standalone pre-insolvency moratorium was introduced with the intention of allowing a company in financial distress a short breathing space in which to explore its options to restructure free from creditor action.

It is overseen by an Insolvency Practitioner ('IP') (who acts as monitor), but the directors of the company remain in control.

However, the entry requirements and widely drafted exclusions make it difficult for companies to use without the support of financial creditors.

Entry requirements include that:

· directors must believe that the company is/likely to become unable to pay its debts; and

· the monitor must be of the view that rescue of the company as a going concern is likely.

The key feature of the pre-insolvency moratorium introduced by CIGA 2020 is that the company benefits from a payment holiday in relation to certain liabilities, but there are widely drafted exclusions including liabilities relating to goods and services supplied during the moratorium, rent for the period of the moratorium, wages and salaries, and debts and liabilities arising under financial services contracts.

Creditors' rights are delayed or suspended while the moratorium exists and the creditors cannot exercise those rights unless the court or the monitor allows. This includes the following:

· no creditor can enforce its security against the company’s assets;

· there is a stay of legal proceedings against the company and a bar on bringing new proceedings against it;

· no winding up procedures can be commenced in respect of the company (unless commenced by the directors) and no shareholder resolution can be passed to wind up the company (unless approved by the directors);

· landlords cannot forfeit leases;

· retention of title creditors and lessors cannot take possession of their assets;

· no administration procedure can be commenced in respect of the company (other than by the directors); and

· no action can be taken to crystallise a floating charge (that is, turn it into a fixed charge).

**Pre-insolvency Moratorium – Lender perspective**

In practice, it is envisaged that companies will only obtain a pre-insolvency moratorium with the support and prior approval from their lenders and even then, may only do so if lenders agree not to exercise their contractual and security rights for a specified period (for example using waivers or some form of agreement).

This is because (1) the company will still be obliged to pay financial creditors and if a payment is missed, this will almost certainly be an event of default, (2) obtaining a moratorium is also likely to be an event of default, and (3) the financial creditors' contractual rights to terminate and demand repayment are not affected by the pre-insolvency moratorium. If lenders did exercise their contractual rights to accelerate and make demand for repayment, the company would almost certainly not be able to pay what was then due. In these circumstances, the monitor is obliged to bring the moratorium to an end. Following termination of the moratorium, the lenders may enforce their security.

If the company cannot pay a debt which must still be paid during the moratorium, when due, the monitor is under an obligation to bring the moratorium to an end.

If the company enters into a liquidation or administration within 12 weeks after the end of the moratorium, certain debts are given a ‘super priority’ status in the statutory order of priority. These two protections are available in respect of debts that are pre-moratorium debts not subject to the statutory payment holiday (such as debts owed to lenders under loan agreements) but the debts will not receive super priority status if they fell due during the moratorium as a result of acceleration or early termination of a loan agreement.

A pre-insolvency moratorium is intended to help a company implement a permanent solution to its financial problems. There are various potential outcomes or exits from a pre-insolvency moratorium. The most important are: (i) the company enters into a consensual restructuring agreement with those creditors needed to enable the company to continue as a going concern, (ii) it seeks to restructure its liabilities using a company voluntary arrangement, scheme of arrangement or restructuring plan, (iii) the directors initiate an administration or liquidation, (iv) the moratorium expires or (v) the monitor brings the moratorium to an end.

**Restructuring Arrangements**

Three possible types of formal arrangement can be made between a company facing distress and certain of its stakeholders, usually proposed by the company with support having been obtained from at least some categories of creditor in advance.

These procedures can be proposed alone or in combination with a liquidation, or more commonly, an administration:

· Scheme of Arrangement under ss.895 - 901 (Part 26) CA 2006

· Restructuring Plan under Part 26A CA 2006 (introduced by CIGA 2020)

· Company Voluntary Arrangement under ss.1-7 IA 1986 (‘CVA’)

**Scheme of Arrangement**

A scheme of arrangement is a formal arrangement or compromise made between the company and one or more classes of creditors and/or members. The basic procedure for a scheme is that (i) permission must be sought from the court to convene meetings of each relevant class of the company’s creditors or members to vote on the scheme proposal; (ii) if the court gives permission the class meetings are held. The scheme proposal must be approved by at least 75% in value and a majority in number of each class of creditors and/or members at the meeting and (iii) the court must then approve (or ‘sanction’) the scheme. The scheme becomes binding on all the company’s creditors affected by it (including those who voted against it) when the court order sanctioning the scheme is delivered to the Companies Registry.

What we see in (ii) above is the ability of a majority of a class to bind a minority of that class. This is an example of **‘intra-class cramdown.’** Restructuring plans also share the feature of intra-class cramdown but they have an additional feature which schemes lack, known as **‘cross-class cramdown’** where, subject to certain safeguards, a court may sanction a plan where one class has voted against a plan, but another class has approved it. We explain cross-class cramdown in more detail later.

We have referred to classes of creditors and members. What constitutes a class is a complex and often contentious matter. The basic rule is that a class is made up of those creditors whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest. One basic class distinction would often be between secured and unsecured creditors.

Because of the cost and complexity, in part due to the court’s involvement, schemes of arrangement have tended to be used to restructure debt obligations of companies with significant secured liabilities and/or complex funding arrangements with tiers of secured and/or unsecured debt, including by foreign companies which have borrowed money from lenders or other creditors under English law financing agreements.

Although there is no automatic moratorium on creditor actions or legal proceedings when a scheme is proposed, companies often succeed in obtaining formal/informal support from financial creditors before the scheme process begins. It is also possible to seek protection from the court against individual creditor action in certain circumstances**.**

**Restructuring plan**

CIGA 2020 has introduced a new formal restructuring plan very closely based on the scheme of arrangement, but with significant distinguishing features. The plan is a court driven process and it becomes binding on all creditors and members following the court sanctioning the plan. Like schemes, creditors and members must be divided into classes and each class that votes on the plan must be asked to approve it.

Key distinctions are that:

· **Restructuring plans can only be used by companies which have or are likely to encounter financial difficulty.** Restructuring plans must consist of a compromise or arrangement used to eliminate prevent or mitigate the impact of financial difficulties that a company is facing.

· **The plan must be approved by at least 75% of each class voting, but there is no majority in number requirement (as there is for schemes).**

· **It may be possible to impose a restructuring plan on a dissenting (or, in some cases, disenfranchised) class in certain circumstances due to the cross-class cramdown mechanism (see below).**

Disenfranchisement

The court may exclude classes creditors and members from voting even if they are affected by the plan if they have no genuine economic interest in the company.

Cross-class cramdown

The court may still sanction a plan if the requisite majority is not obtained in one or more classes if (i) none of the dissenting class would be worse off than in the relevant alternative (usually a liquidation); and (ii) at least one class who would have a genuine economic interest in the relevant alternative, votes in favour. If a court is to sanction a plan where a class has not approved it, the court must be satisfied that the plan provides a fair distribution of benefits generated by the restructuring between the classes that approve the plan and those that do not. This means if the relevant alternative to a plan is formal liquidation or administration under which the approving and dissenting creditors would be treated on a pari passu basis, the plan should do so as well unless there is some good reason to justify some other treatment e.g.; the approving creditors are providing new loans to assist the restructuring for the benefit of creditors as a whole.

A restructuring plan has one important advantage over a CVA: it can compromise the rights and claims of secured creditors and shareholders. A CVA cannot do this.

The restructuring plan has an advantage over a scheme in that a scheme is only binding on those classes of creditors or shareholders who vote in favour of it. Schemes of arrangement do not have a cross-class cramdown mechanism.

Schemes of arrangement can be used by companies not facing distress. Restructuring plans can only be used by companies facing actual or prospective financial difficulty. In contrast, a scheme can be used by any company, solvent or otherwise.

An administrator and liquidator have the power to propose a restructuring plan (or a scheme) but in most cases it will be the directors who will do so. In certain circumstances, the directors might consider obtaining a pre-insolvency or going into administration as an initial step to commencing the restructuring plan procedure in order to obtain the protection of a moratorium but, as with schemes, this rarely happens in practice.

**Company Voluntary Arrangement**

A CVA is another procedure for achieving a compromise or arrangement between a company and its creditors but can only bind non-preferential unsecured creditors. A CVA is usually less costly and quicker than a scheme of arrangement or restructuring plan, mainly because it does not require the sanction of the court.

Often, the purpose of a CVA is to seek to put in place a timetable for the repayment (usually only in part) of liabilities owed to (usually) non-preferential unsecured creditors. Alternatively, where rescue is not feasible, CVAs can be used to achieve a more efficient asset realisation and distribution to creditors than would be the case in a *winding up*.

To implement the CVA, the directors of the company, usually advised by an insolvency practitioner acting as a nominee, formulate a written proposal for the repayment or restructuring of the company’s liabilities. The proposal will include a term that the nominee will act as supervisor of the CVA once it has been approved.

Note that a liquidator and administrator have the power to propose a CVA. If they do so, they will be the nominee and supervisor of the CVA.

**CVA - approval**

Once the proposal has been finalised the nominee will seek creditors’ approval for the CVA using one of a number of permitted decision-making procedures provided for under the IR 2016.

Once the creditors’ decision has been made, the nominee must call a separate meeting of the company’s shareholders.

**Two creditor majorities are required if the CVA proposal is to be approved:**(1) at least 75% in value of those creditors who vote on the CVA proposal vote in favour of it. There is no requirement for a majority in number of creditors to vote in favour (in contrast to a scheme). (2) Those voting against the proposal must not be more than 50% in value of unconnected creditors (e.g. the claims of related companies must be ignored for this purpose). The members approve the CVA by passing an ordinary resolution.

For voting purposes, a debt of an unliquidated or unascertained amount is valued at £1 unless the chairperson overseeing the voting procedure places a higher value on it. This has been key to allowing CVAs to be used to restructure leasehold liabilities.

**CVA - effect**

If approved by the requisite majorities of creditors and members (or if the members vote against, by the creditors alone), the CVA proposal binds all creditors: those who voted for the CVA, those who voted against it, those who did not vote at all and those creditors who did not receive notice of the decision-making procedure adopted to approve the CVA. All those creditors’ claims are then dealt with in accordance with the terms of the CVA.

A CVA cannot compromise the rights of a secured creditor (including the right to enforce security) or the rights of a preferential creditor without that creditor’s consent**.** In practice, secured creditors rarely agree to be bound by a CVA. In order to achieve a restructuring of secured liabilities a company would have to (i) seek a consensual agreement with its secured creditors (which may be conditional on unsecured creditors voting in favour of a CVA on certain terms) or (ii) seek approval of a scheme of arrangement or a restructuring plan.

A creditor can challenge a CVA within a 28-day period(commencing with the date of filing at court of the nominee’s report on the approval of the CVA, or within 28 days of the day on which the creditor became aware of the decision procedure having taken place) by making an application to court on grounds of:

**'unfair prejudice':** i.e. one creditor has been treated unfairly under the CVA (compared to another creditor or to what the creditor’s position would have been if the company had entered into an insolvency process; and/or

**'material irregularity':** relating to the procedure which the company has followed in seeking the approval of the CVA (such as the way that creditors’ votes were calculated).

Subject to the court’s decision on a creditor challenge, a CVA becomes binding on all creditors at the end of the 28-day challenge period.

**The supervisor’s role**

Where the directors propose a CVA, the directors remain in place during the CVA and will be able to exercise their usual powers unless the CVA proposal provides otherwise. The supervisor’s role will be to agree creditors’ claims, collect in the funds which the company is to use to pay dividends to the creditors on their agreed claims and generally ensure that the company complies with its obligations under the CVA.When a CVA has been completed, the supervisor will send a final report on the implementation of the proposal to all members and creditors who are bound by the CVA, then step down from his/her role and the company will carry on under the management of its directors in the normal way.

**CVAs used in conjunction with other pre-insolvency and insolvency procedures -** A company may consider obtaining a pre-insolvency moratorium or going into administration or liquidation before proposing a CVA because an administrator and liquidator have the power to propose a CVA. A company would do this in order to receive the benefit of a moratorium to prevent creditors from taking hostile action during the period between the sending out of notice to the creditors of the CVA decision-making procedure and the holding of the procedure itself which will be at least 14 days. This has not been a frequent occurrence in practice to date.

**Summary**

· We have seen how CIGA has introduced the new pre-insolvency moratorium and restructuring plans.

· The pre-insolvency moratorium is designed to give a company a temporary respite from hostile creditor action in order to give it time to implement a permanent solution to its financial problems. Before obtaining this moratorium, the company will need the prior approval of its lenders.

· Formal restructuring procedures include a company voluntary arrangement, scheme of arrangement and a restructuring plan.

**Insolvency procedures**

This element insolvency procedures which may be used when a company is in financial difficulties.

**Administration – Schedule B1 of IA 1986**

Administration is an insolvency procedure introduced by the IA 1986. It was significantly amended by the EA 2002.

An important feature of administration is the creation of a moratorium which continues throughout the period of the administration. This provides the company in administration with a breathing space to achieve the purpose of the administration, as the moratorium prevents creditors without court or administrator consent from exercising their usual rights and remedies. Examples of creditor actions prevented during a moratorium include: the right to enforce their security; or in the case of a landlord, from attempting to terminate a lease by exercising a right of re-entry; or in the case of a creditor who has supplied goods on retention of title, from attempting to take possession of the goods to which it has title.

Administrators can be appointed either by court order or out of court (usually by directors or holders of “qualifying floating charges”- see later).

The **primary objective** of the administrator is the **rescue** of the company as a going concern.

If the rescue of the company is not reasonably practicable, then the administrator’s objective will be to achieve a better result for the company’s creditors as a whole than would be likely if the company were wound up without first being in administration.

Only when neither of the first two options are reasonably practicable and provided an administrator does not unnecessarily harm the interests of the creditors as a whole, then the final objective of the administrator will be to **realise property** in order to make a **distribution** to one or more **secured** or **preferential creditors** (Schedule B1 paragraph 3(1) IA 1986).

In reality, company rescue is rarely achieved. In most administrations, the relevant statutory objective is the second one.

**Qualifying Floating Charges**

In practice the most important and common form of security is a **debenture** which consists of fixed charges over most categories of a company’s assets together with a residual floating charge over any of the company’s assets not otherwise subject to a fixed charge. The debenture will usually include a provision giving the debenture holder (in a bilateral loan this is normally a lender whereas in a syndicated deal this would be the security trustee) the right to appoint an administrator following the occurrence of an event of default under the loan agreement. This right is the central remedy available to a debenture holder to enforce its security.

The debenture holder has the right to appoint an administrator only if the floating charge created by its debenture is a **Qualifying Floating Charge** (‘**QFC**’). This is defined in Schedule B1, paragraph 14 IA 1986 and includes a floating charge over the whole or substantially the whole of the company’s property (either alone or in conjunction with other security which the holder of the floating charge has) and the charging document either states that paragraph 14 applies to the floating charge or purports to give the holder of the floating charge the right to appoint either an administrator or an administrative receiver. The holder of such a charge is called a Qualifying Floating Charge Holder (‘**QFCH**’). Nearly always, the debentures created in practice are QFCs.

A floating charge has the following characteristics:

a) it is a charge over a class of assets of the debtor/chargor;

b) the particular assets within the class change from time to time in the ordinary course of the chargor’s business; and

c) the chargor remains free to deal with those assets in the ordinary course of its business until crystallisation of the charge (e.g. on winding up or other event specified in the debenture).

Assets most commonly subject to floating charges are book debts, stock and cash in current accounts. Lenders will usually seek to take fixed charges over all other categories of assets.

A floating charge is a charge which, when created, was a floating charge and therefore includes any floating charge which has crystallised (i.e. converted into a fixed charge either as a matter of law or pursuant to the terms of the debenture).

**Appointing an administrator**

The following parties can apply to the court for an administration order:

· the company itself (i.e. acting with the authority of a resolution passed by the members in general meeting);

· the directors of the company (by board resolution);

· a QFCH;

· a creditor (who is not a QFCH);

· the supervisor of a CVA; and

· a liquidator.

The following parties can use the out-of-court procedure to appoint an administrator:

· the directors of the company;

· a QFCH; and

· the company acting through its members.

**Appointing an administrator- out of court**

The most common method for appointing administrators is a directors’ out-of-court appointment. This is true even if there is a QFCH as QFCHs often do not like the publicity associated with appointing administrators. That said, a first ranking QFCH will usually be able to influence the timing of appointment and the identity of the administrator.

Appointments by the company (acting through the members) are very rare. Appointments by court order are fairly uncommon and usually occur when a creditor has begun winding up proceedings against the company and the directors wish to appoint administrators before the court has made a winding up order. In this situation, the out-of-court appointment procedure is not available to the directors and they must apply to court for an order to appoint administrators. If the court makes an administration order, the pending winding up proceedings are automatically dismissed.

Contrast the position where there is an outstanding winding-up petition and a QFCH uses the out-of-court procedure to appoint an administrator. In this case the petition is automatically suspended rather than dismissed.

**Appointing an administrator – out of court (QFCH)**

The out-of-court procedure differs depending on who appoints the administrator. ​

If a QFCH appoints the administrator, it files a notice of appointment at court and the appointment commences on the date of the filing (subject to serving notice on any prior QFCH and to the rules on out of hours appointment). ​This is only possible where the QFC is valid and has become enforceable. The QFC will become enforceable if (i) the debenture and/or the loan agreement provides that the lender’s security is enforceable following the occurrence of an event of default, (ii) the lender accelerates the loan so that all advances under the loan are immediately due and payable and are repayable on demand, (iii) the lender makes written demand on the borrower for immediate repayment and (iv) the borrower fails to satisfy the demand

If the directors or the company appoint the administrator, then they must file notice of intention to appoint an administrator at the court and serve it on any QFCH, identifying the proposed administrator and giving the QFCH five business days’ notice of its intention to file a notice of appointment with the court. The QFCH then may appoint its own choice of administrator within the five business day period (assuming its security is enforceable and it has the right to appoint administrators at this point of time) or it will liaise with the directors in relation to the appointment process.​ The directors may only appoint an administrator if the company is/likely to become unable to pay its debts.

**Appointing an administrator – out of court (directors)**

The directors will file a notice of appointment with the court within a further five business day window. The administrators are appointed immediately on the filing of the notice of appointment.

The QFCH is usually able to override the directors’ or company’s choice of administrator. In practice the appointment of an administrator usually takes place at a time decided upon by the QFCH and the QFCH will liaise with the directors when it is ready and request the directors to appoint the administrators which it has chosen.

In such a case, the appointment can take place very quickly and it is usually possible for the directors to file the notice of intention to appoint administrators, to obtain the consent of the QFCH to the appointment and then to file the notice of appointment within a few hours.​

**Appointing an administrator – court appointments**

In certain circumstances, a court appointment will take place, including appointment by a creditor who is not a QFCH (though these are rare as such creditors will find presentation of a winding-up petition more straight forward).

The most common situation when an administrator is appointed by the court is when a creditor has presented a winding up petition against the company and the directors then seek to appoint administrators. They can only do so by making a court application.

**Administration moratorium**

The appointment of an administrator creates an immediate moratorium on certain creditor action whereby (except with consent of the court or the administrator in each case):

· no order or resolution to wind up the company can be made or passed;

· no administrative receiver of the company can be appointed;

· no steps can be taken to enforce any security over the company’s property or to repossess goods subject to security, hire purchase and retention of title;

· no legal proceedings, execution or other process can be commenced or continued against the company or its property; and

· a landlord cannot forfeit a lease of the company’s premises by means of peaceable re-entry.

There is also an interim moratorium if an application is made to court for the appointment of an administrator or a notice of intention to appoint the administrator is filed. Neither of these steps prevents a QFCH from appointing its own choice of administrator out-of-court (assuming its security is then enforceable and gives it the right to appoint an administrator).

**Powers and duties of the administrator**

Pending the appointment of an administrator, the directors remain in control of the company. The administrator usually takes on the management of the business in place of the directors once appointed.

**Duties -** the administrator will manage the company and its business with the aim of achieving the purpose of the administration. The directors are unable to exercise any management power without the consent of the administrator.The administrator acts as agent of the company and incurs no personal liability on contracts he causes the company to enter into provided he acts within his or her powers. The administrator is an officer of the court (even if appointed using the out-of-court procedure) and has a duty to the court and a duty to act in the interests of all the creditors.

**Powers -** administrators have wide powers set out in paragraph 1 of Schedule B1 to the IA 1986. These powers include: the carrying on of the business of the company; taking possession of and selling the property of the company; raising money on security; and executing documents and deeds in the company’s name.

As a general rule administrators do not have the power to pay a dividend to unsecured creditors without obtaining court permission. They can (and often do) pay a dividend to secured creditors out of the proceeds of the creditor’s security and can now (as result of the changes brought about by the Small Business Enterprise and Employment Act 2015) pay the prescribed part dividend to unsecured creditors out of the “prescribed part” (or ring-fenced) fund (see below).

If there is a dividend to be paid to unsecured creditors, this will be paid in the statutory order of priority and either the administrator will have to seek permission from the court to make the payment or the administration will convert into a liquidation and the liquidators will then make a distribution to creditors. In a more complex case, the administrator will propose a restructuring plan, a CVA or a scheme of arrangement on terms that the administrator has the power to make dividend payments.

Recoveries for unsecured creditors are usually low.

In practice, the administrator will often sell all/part of the business on or shortly after they have been appointed (usually by means of a pre-agreed or pre-packaged sale) (a 'pre-pack'). Under a pre-pack the putative administrators negotiate the terms of the sale with the proposed buyer in advance of their appointment. The parties will sign the sale agreement and the signed counterparts will be held in escrow pending the administrators’ appointment. The advantage of the pre-pack to secured creditors is that it provides certainty of result as they will know before the administrator’s appointment what return they will receive from the pre-pack sale.

**Powers and duties of the administrator- swelling the assets of the insolvent estate**

The administrator (like a liquidator) has powers under the IA 1986 to apply to court and ask the court to make an order to set aside (avoid, or “claw back”) certain voidable transactions which occurred in defined periods before the start of the administration.

They are known as “antecedent transactions”, and you will be familiar with these from Business Law on the SQE 1 Preparation course. The two most well-known examples are transactions at an undervalue and preferences.

These orders are sought with the aim of increasing the pool of the company’s assets available to creditors.

Under the changes brought about by the Small Business, Enterprise and Employment Act 2015, administrators, like liquidators, now also have the power to bring claims against directors for wrongful or fraudulent trading.

**Ending administration**

The administrators’ appointment terminates automatically after 12 months. This period can be extended once by up to one year if the creditors agree. The court can also sanction any other extensions (which may be for more than one year).

Administrators can, in certain circumstances, bring the administration to an end without court involvement by filing the appropriate notice with the court. An example of when this procedure can be used is when an out-of-court appointed administrator believes that the purpose of the administration has been sufficiently achieved.

As mentioned above, administration may also be followed by another restructuring procedure (such as a CVA, restructuring plan or scheme) or by a liquidation.

**Fixed Charge Receivers**

A fixed charge receiver (“**FCR**”) is, as the name suggests, appointed by the holder of a fixed charge in the circumstances set out in the loan or security documentation (e.g. on the occurrence of the usual types of events of default found in loan agreements). The FCR will have certain limited powers set out in the Law of Property Act 1925 (‘**LPA 1925**’) and any additional powers (which are generally fairly extensive and include a power of sale) set out in the security documentation.

A fixed charge receiver becomes the receiver only of the property charged and is only entitled to deal with that property. The FCR is not normally entitled to deal with any other property of the company or to manage the company’s business. Fixed charge receivers are sometimes referred to as “**LPA receivers**”. Technically speaking, they are different. Fixed charge receivers are appointed pursuant to powers contained in a fixed charge or mortgage whereas an LPA receiver is appointed under the terms of the Law of Property Act 1925. Most receivers encountered in practice are fixed charge receivers because, as referred to above, this type of receiver has a more extensive set of powers.

· A fixed charge receiver cannot be appointed while a pre-insolvency moratorium subsists or if the company is in administration.

· Fixed charge receiverships are more likely to be used in relation to companies with significant assets subject to fixed charge(s) e.g., real estate.

· They are a ‘self-help' remedy, not a collective insolvency procedure.

**Administrative receivers**

Until the implementation of the EA 2002, debentures generally provided lenders with a quick and (compared with administration) cheaper method of enforcement through the appointment of an administrative receiver (‘**AR**’). Technically, the appointment of an AR is not an insolvency procedure but a 'self-help' procedure to enable a secured creditor to enforce its security by the realisation of the assets secured by the debenture.

The EA 2002 effectively abolished administrative receiverships under charges created on or after the *Relevant Date*, except in respect of floating charges created as part of some special transactions. The detail of these transactions is beyond the scope of this workstream.

As ARs owe their duty primarily to their appointor, chargeholders which took their security before the Relevant Date may be considered in a better position than holders of QFCs created after the Relevant Date, who can only appoint an administrator.

However, lenders have become comfortable with the administration procedure and an appointment of an AR under a floating charge created before the Relevant Date is extremely rare.

An AR cannot be appointed if a pre-insolvency moratorium subsists or if the company is in administration.

**Appointment of administrative receivers**

The holder of a floating charge created before the Relevant Date can appoint an AR without much formality, provided that the floating charge together with any other security the holder has is over the whole/substantially the whole of the company's property and expressly provides that the holder may appoint an administrative receiver (s.29(2) IA 1986).

The appointment can be made very quickly (usually within a few hours on a business day) either (i) following the occurrence of an event of default under the terms of the relevant loan agreement and the charge holder accelerates the loan and makes demand for immediate repayment and the debtor does not satisfy the demand, or (ii) where the loan is repayable on demand (such as an overdraft), following the charge holder making demand for immediate repayment and again, the debtor does not satisfy the demand.

**Powers of administrative receivers:**

· All the express powers are set out in the debenture (the security documentation incorporating the floating and fixed charges); and

· Unless expressly excluded, the AR also has extensive powers set out in Schedule 1 to the IA 1986 (these are the same powers that are granted to an administrator).

The AR’s most important power is to take possession of and sell the assets of the company and repay the debenture holder. An AR does not have the benefit of a moratorium. This means that during the receivership, a creditor has the right to seek to exercise its rights and remedies e.g. to petition to wind up.

**Role and duties of the administrative receiver**

The AR is required to be a licensed insolvency practitioner.

Although nominally the agent of the company, ARs owe a primary duty to **their appointor**, and generally owes only a limited duty to the company and other creditors. The company as principal is not able to give instructions to the AR.

The AR is both a receiver and a manager (as stated above fixed charge receivers are receivers only and are not normally entitled to manage a company’s business). The AR’s role is to take possession of the assets secured by the charge under which he or she is appointed. Usually the assets are sold (preferably on a going concern basis), with the AR and his or her staff in the meantime running the business with the assistance of existing workforce (and perhaps the existing management).

The order of priority for payments on the realisation of assets by the AR is essentially the same as on winding up.

**Liquidation (or ‘winding up’) – ss.73 – 229 of IA 1986**

Liquidation is the oldest of the corporate insolvency procedures. The liquidator’s function is to realise the company’s assets for cash, determine the identity of the company’s creditors and the amount owed to each of them and then pay a dividend to the creditors on a proportionate basis relative to the size of their determined claims (creditors of the same rank are said to rank ‘pari passu’).

The ranking of creditors’ claims (that is, the order in which they must be repaid) is set out in the IA 1986, the IR 2016 and by general law.

Liquidation is not a rescue mechanism and a liquidator has only very limited powers to carry on the business of a company**.** Liquidators will usually close a company’s business and dismiss employees very soon after their appointment and sell assets on a piece-meal basis rather than selling the assets and business as a going concern.

In a compulsory winding up (discussed later), there is a very limited statutory moratorium involving a bar on bringing or continuing legal proceedings against the company. For this reason, administration is usually preferable, at least initially, if sufficient funds are available to fund the administration. In particular, the ability of an administrator to maximise value for creditors by selling a business as a going concern is an important advantage of administrations over liquidations.

**Types of liquidation**

There are two **types of liquidation**:

· Compulsory

and

· Voluntary

Voluntary liquidations are further divided into:

Members' voluntary liquidations (which are solvent liquidations)

and

Creditors' voluntary liquidations (which are insolvent liquidations)

**Compulsory liquidation**

· Compulsory liquidation is a court-based process for placing a company into liquidation.

· To begin the process an applicant (called a ‘petitioner’) presents a winding up petition to the court under which the petitioner requests the court to make a winding up order against the company on one of a number of statutory grounds.

· The court issues the petition and fixes a date for the hearing of the petition. The petitioner then serves the petition on the company. There are restrictions on the directors' ability to take certain actions between the service of the winding up petition and the court hearing.

**The following can apply to the court for the issue of a winding up petition:**

1) a creditor;

2) the company (acting by the shareholders; this would happen where there are insufficient assets in the company to fund a voluntary liquidator);

3) the directors (by board resolution); again, this would happen where there are insufficient assets to fund a voluntary liquidator;

4) an administrator;

5) an administrative receiver;

6) the supervisor of a CVA; and

7) the Secretary of State for Business, Energy & Industrial Strategy (on public policy grounds).

Given the ability of a QFCH to appoint an administrator, where the QFC becomes enforceable, it is usually an unsecured creditor who will apply to the court for a winding up order.

A secured creditor which holds only fixed charges (and so is not a QFCH) will usually enforce against the assets subject to its fixed charges by appointing a fixed charge receiver and will not usually resort to issuing a winding up petition.

**Grounds of petition for liquidation**

The usual grounds are:

· the company’s inability to pay its debts (s.122(1)(f) of IA 1986); or

· the court being of the opinion that it is just and equitable that the company be wound up (s.122(1)(g) of IA 1986).

Technically, the just and equitable ground to wind up a company is not an insolvency situation.

**Demonstrating inability to pay debts**

There are a number of ways in which a company may be deemed to be unable to pay its debts for the purposes of a winding-up petition:

1) Failure by the company to comply with a creditor’s statutory demand. A statutory demand is a written demand in a prescribed form requiring the company to pay a specific debt. The statutory demand can only be used if the debt exceeds £750 and is not disputed on substantial grounds. The company has 21 days in which to pay the debt, failing which the creditor has the right to petition the court to wind up the company. This is the most common route basis for a winding-up petition.

2) The creditor obtains a judgment against the company and fails in an attempt to execute the judgment debt.

3) Proof to the satisfaction of the court that the company is unable to pay its debts as they fall due (the “**cash-flow test**”). The cash flow test is usually satisfied by going through the statutory demand process in 1 above but that is not essential.

4) Proof to the satisfaction of the court that the value of the company’s assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities (the “**balance sheet test**” although case law shows this is not a pure accounting exercise).

**Voluntary liquidation**

**Creditors’ voluntary liquidation (‘CVL’) –** this is a form of insolvent liquidation commenced by resolution of the shareholders but under the effective control of the creditors who can choose the liquidator.

The procedure is for the shareholders to pass a special resolution to place the company into a CVL. The shareholders may also nominate a person to be liquidator, but in any event within 14 days after the special resolution has been passed, the directors of the company must ask the company’s creditors either to approve the nominated liquidator or to put forward their own choice of liquidator. Where the creditors’ choice of liquidator differs from that of the company’s shareholders, the creditors’ nomination will take precedence. The directors must also draw up a statement of the company’s affairs (setting out the company’s assets and liabilities) and send it to the company’s creditors.

**Effect of the pre-insolvency moratorium**

A company cannot be placed into any type of liquidation while a pre-insolvency moratorium subsists (unless approved by the directors) or if the company is in administration.

**Liquidator’s powers and duties**

The liquidator acts asagent of the company and has extensive statutory powers. Generally, the directors lose their powers upon the liquidator’s appointment. The liquidator’s powers include:

· To collect in and realise the company’s assets and to distribute them in the statutory order of priority.

· To make any compromise or arrangement with creditors.

· To bring in or defend any action or legal proceeding in the name of and on behalf of the company.

· To maximise the assets available for distribution to the company’s creditors by:

**- challenging voidable antecedent transactions** or bring a claim against one or more of the directors for wrongful or fraudulent trading. Liquidators (and administrators) also have the power to assign the right to wrongful and fraudulent claims as well as preference and transactions at an undervalue causes of action. This allows them to realise some money for the benefit of the estate without assuming the risk of litigating the claims; and

**- disclaiming onerous property** (**s.178**) e.g. onerous, unsaleable or unprofitable contracts. This is available equally in both solvent and insolvent liquidations. The most important example of onerous property is a lease of land. When notice of disclaimer is given by the liquidator, all rights, interests and liabilities of the company in respect of the property cease. A person who suffers any loss resulting from a disclaimer is entitled to prove in the liquidation as an unsecured creditor, or in certain circumstances, to apply to the court for an order to have disclaimed assets vested in him.

**Proceedings against the company**

After presentation of a petition and before a winding up order is made, the company, or any creditor or contributory, can apply to the court to request it to make a provisional order to stay any action or proceedings then current against the company.

The effect of a winding up order will be automatically to stay any action or proceedings against the company, unless the court otherwise determines.

**Members’ voluntary liquidation (‘MVL’) -** the MVL procedure can only be used if the company is solvent because a necessary part of its procedure is that the directors must make a statutory declaration of solvency. Under the declaration, they must state the company will be able to pay its debts in full within a period specified in the declaration (not exceeding 12 months from the commencement of the winding up) with the risk of criminal liability if a director makes a declaration without reasonable grounds.

The statutory declaration must attach a simplified form of balance sheet listing and giving values for the company’s assets and liabilities and showing that the assets exceed the liabilities.

The shareholders pass:

· a special resolution to place the company into an MVL; and

· an ordinary resolution appointing a liquidator.

Notice of intention to put a resolution for voluntary liquidation to the shareholders must be given in advance to any QFCH. The MVL will be converted into a creditors’ voluntary liquidation if the company becomes unable to pay its debts within the period (for all intents and purposes one year) specified in the statutory declaration.

**Summary**

· Administration is the main English law insolvency procedure. It must be conducted with a view to achieving one of the three statutory objectives. The most important is the second: to achieve a better result for creditors than would be achieved in a liquidation

· Fixed-charge receivership and administrative receivership are self-help security enforcement procedures rather than collective insolvency procedures.

· Liquidation is a procedure used to wind up the company. It involves the liquidator realising the company’s assets and distributing them to creditors by way of a dividend in accordance with the statutory order of priority.

**Order of priority**

This element examines the order of priority for payment of creditors of a company when it is wound-up.

**Order of priority in an insolvent liquidation or administration:**

1) Insolvency office holder's fees, costs and expenses incurred in preserving and realising assets subject to a fixed charge

2) Fixed charge creditors in respect of assets subject to a fixed charge

3) Other costs and expenses of liquidation/administration

4) Preferential debts (there are two tiers of preferential debts)

5) Prescribed part funds

6) Floating charge creditors

7) Unsecured creditors

8) Interest on unsecured (including preferential) debts

9) The shareholders

**Fixed charge creditors (in respect of assets subject to a fixed charge)**

· The proceeds of selling assets which are subject to a fixed charge (or mortgage) must first be used to pay the insolvency office-holder's costs, expenses and associated fees and expenses of realising those assets, then to pay off the debt secured by such charge (or mortgage). The term ‘expenses’ includes the professional fees of lawyers and other service providers engaged by the office holder.

· If the proceeds are not sufficient to discharge the debt in full, then the creditor must seek payment of the balance at an appropriate later point in the order of priority. This will depend on whether or not the same debt was also secured by a floating charge.

· The proceeds of selling the fixed charged assets will form the fixed charge fund. Only elements 1 and 2 in the statutory order of priority may be paid out of the fixed charge fund.

**Other costs and expenses of liquidation**

· This includes all other fees, costs and expenses of the administration/liquidation, including the costs of selling assets secured by a floating charge, debts arising out of contracts entered into by the liquidator or administrator or arising from litigation which the liquidator or administrator has brought.

**Preferential debts**

· For insolvencies occurring on or after 1 December 2020, there will be two tiers of preferential debts. The first tier (called ordinary preferential debts) must be paid in full before the second tier (called secondary preferential debts) can be paid. Ordinary preferential debts consist of mainly (i) employees for remuneration due in the four months before the ‘relevant date’ (generally the date of the commencement of the liquidation or administration) but subject to a maximum of £800 per employee, plus accrued holiday pay and (ii) certain contributions owing to an occupational pension scheme.

· The secondary preferential debts consist of debts due within certain prescribed periods to HM Revenue and Customs in respect of PAYE, employee national insurance contributions and VAT. These represent taxes which companies collect on behalf of HMRC from third parties (employees and customers).

**Prescribed part fund**

· The EA 2002 introduced the ‘prescribed part’ fund into the IA 1986 to increase the chance that unsecured creditors would get paid something in a liquidation or administration. The prescribed part fund is sometimes referred to as the “ring fenced” fund.

· The prescribed part fund is calculated by reference to a certain percentage (the ‘prescribed part’) of the company’s ‘net property.’ This is set aside (ring-fenced) for distribution to the company’s unsecured creditors; s.176A IA 1986. ‘Net property’ means the proceeds of selling property other than that which is subject to a fixed charge, after deduction of the liquidator’s fees, costs and expenses and any preferential debts (s. 176A (6) IA 1986).

· The amount of the company’s net property that will form the prescribed part fund is 50% of the first £10,000 and 20% thereafter up to a maximum fund of £600,000 for floating charges created before 6 April 2020 and £800,000 for floating charges created on or after that date. The ring-fencing provisions do not apply where the net property of the company is less than £10,000 as the cost of distributing the fund would be disproportionate to the benefit; see the Insolvency Act 1986 (Prescribed Part) Order 2003.

· The prescribed part fund is a pot of money set aside for distribution rateably among the unsecured creditors when they are paid. It should be noted that for this purpose, a floating charge holder who suffers a shortfall on floating charge realisations does not share in the prescribed part fund, although the shortfall does constitute an unsecured claim against the company.

**Floating charge creditors**

· After payment of the general expenses of the insolvency process, paying preferential debts and dealing with the prescribed part, the office holder then pays any remaining realisations from assets subject to floating charges to the floating charge holders themselves (according to the priority of their security if there is more than one floating charge holder).

· The proceeds of selling the company’s assets not subject to a fixed charge constitutes the floating charge fund. Elements 3 to 6 (other costs and expenses of liquidation, preferential debts, prescribed part fund and floating charge creditors) of the statutory order of priority will be paid out of the floating charge fund.

**Unsecured creditors**

For example:

· ordinary trade creditors who have not been paid;

· secured creditors to the extent that the security is invalid or assets subject to the security have not realised sufficient funds to pay off the secured debt; and

· employees’ outstanding remuneration to the extent that it does not rank preferentially.

All the unsecured creditors rank and abate equally. This is known as the ‘pari passu’ rule. For example, if a company has only two creditors (A and B) and creditor A has a claim against the company of 100 and creditor B has a claim against the company of 50 (making total claims of 150) but the assets available for distribution to the creditors are 75, creditor A will receive 50 and creditor B will receive 25. Note that secured creditors who have not been paid in full of the realisation of assets subject to their security can only claim for their shortfall as unsecured creditors against realisations from unsecured assets because they are not eligible to any payment from the prescribed part fund.

**Interest on unsecured (including preferential debts)**

Interest accruing on unsecured debts from the commencement of the winding up.

**Shareholders**

· The shareholders who participate in the equity of the company will rank last. However, their rights, as between themselves depend on the rights attributable to their particular class or classes of shares.

· These rights are set out in the company’s Articles of Association. For example, preferential shareholders may have preferential rights to a return of their capital on a winding up in priority to ordinary shareholders.

**Summary**

Assets are distributed by a liquidator/administrator in the statutory order of priority, being:

1) Insolvency office-holder’s fees, costs and expenses incurred in preserving and realising assets subject to a fixed charge;

2) Fixed charge creditors (in respect of assets subject to a fixed charge);

3) Other costs and expenses of the insolvency process;

4) Preferential debts;

5) Prescribed part fund;

6) Floating charge creditors;

7) Unsecured creditors;

8) Interest on unsecured (including preferential) debts; and

9) Shareholders.

**Types of security**

This element explains the different types of security interest available to a lender, the assets that may be secured and some practical and commercial considerations when taking security.

**Main types of security**

* Assignment by way of security (e.g. borrower's rights against a third party)
* Taking physical possession of asset:
  + Pledges
  + Liens
* Transferring ownership in asset:
* Mortgages
* Giving rights over assets:
* Charges

**Charges**

**What is a charge?**

A charge is an equitable, proprietary interest in and to the asset.

**What does the lender achieve?**

A charge gives the lender the right to have recourse to the charged asset in order to satisfy the secured debt. There is no transfer of title to the asset itself.

The main types of charges are fixed and floating charges which we will look at in further detail on the next slide.

**Fixed Charges**

A fixed charge attaches to an asset as soon as the charge is created. It gives the lender a claim over the proceeds of sale of that asset in priority over other creditors of the borrower.

For a fixed charge to be validly and effectively created as such (so that it is not instead classed as a floating charge), the lender has to show a sufficient level of **control** over the asset. This is normally done by insisting, in the security document, that the owner of the asset (the borrower) gets the consent of the lender to deal with the asset, e.g. to sell it or to create further charges over it.

If the borrower sells an asset subject to a fixed charge, the buyer of that asset takes subject to the fixed charge as long as it has notice of the charge. Provided the fixed charge has been registered at Companies House in accordance with s. 859A-Q CA 2006, the buyer will have 'actual notice' of the fixed charge if it carries out a search of the charges register. The law is unclear as to whether registration would operate as 'constructive notice' on a buyer who has not carried out a search of the charges register, but further consideration of this point is outside the scope of this knowledge stream.

A key element of a fixed charge to consider is that it will not be suitable for every type of asset, because a fixed charge will severely limit the borrower’s ability to deal with that asset.

**Floating Charges**

There are certain types of asset which the borrower needs to be able to deal with freely as part of its business, such as stock. The value of such assets will therefore regularly fluctuate. The most appropriate form of security for fluctuating assets is a floating charge.

Under a floating charge, a borrower is able to deal with the charged assets in the ordinary course of its trade – e.g. to sell, hire or lease them without first obtaining the consent of the lender.

A floating charge ‘floats’ over the charged assets until the occurrence of certain events. On the occurrence of one or more of these events, the charge ‘crystallises’ and fixes on the charged assets. The floating charge effectively becomes a fixed charge, in that the borrower no longer has the ability to deal with the assets over which the charge has crystallised without the lender’s consent.

However, for insolvency purposes the charge itself is still treated as a floating charge for insolvency ranking. This means that the proceeds of sale of the assets subject to it will be applied in paying the fees, costs and expenses of the relevant insolvency office-holder, the debts owed to preferential creditors and in setting aside the prescribed part fund (discussed later) before being applied in satisfaction of the debt owed to the floating charge holder.

**Crystallisation of floating charges**

Crystallisation can occur as a matter of law on the following certain events:

* on the liquidation of a borrower;
* on the appointment of a receiver; or
* if the borrower ceases to carry on business.

A typical security document contains a list of additional triggers, for example an event of default under the loan agreement or any event which, in the opinion of the lender, would put the assets in jeopardy. If any of these events occurs then the floating charge would crystallise.

**How to identify a floating charge?**

**Key case: Yorkshire Woolcomber's Association Ltd [1903] ('Yorkshire Woolcombers')**

In this case the court discussed the characteristics of a floating charge. It was held that a charge would be deemed floating if:

* it is a charge on a class of assets of a company present and future;
* that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and
* by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets.

**Distinction between a fixed and floating charge**

**Key case: National Westminster Bank plc v Spectrum Plus Limited and others** **[2005] UKHL 41** (**‘Spectrum’**).

The House of Lords reviewed the distinction between fixed and floating charges in the above case. The judges generally approved the Yorkshire Woolcomber’s definition but focused particularly on the third element of that definition (i.e., until action is taken by the lender the borrowing company may carry on its business using those assets in the ordinary course of its business).

According to the leading judgement, the essential characteristic of a floating charge, which distinguishes it from a fixed charge, is that “the asset subject to the charge is not finally appropriated as security for payment of the debt until the occurrence of some future event. In the meantime, the borrower is left free to use the charged asset and to remove it from the security”. Conversely, it is an essential characteristic of a fixed charge that assets can be disposed free from the security only with the “active concurrence” of the lender.

Note that the **substance** of the charge is more important than the **label** applied by the parties. To determine whether a charge labelled as fixed by the parties is in fact floating, you need to look at the element of **control** over the asset granted by the charging document, and the nature of the charge evidenced by the terms of the security document, **not** the name which the parties have given to the charge.

**Key case: Re Avanti Communications Limited (in administration) [2023] EWHC 940 (Ch) (‘Re Avanti’).**

The recent case of Re Avanti is the first major case to have considered the Spectrum principles further in relation to the control required for a fixed charge.

In Re Avanti, the High Court held that there should be a more nuanced approach than that taken in Spectrum and that it will not always be necessary for there to be an absolute prohibition on the chargor (i.e. the party providing security) dealing with the charged assets for a fixed charge to be valid.

Instead, there should be a number of factors taken into consideration, including:

* + The nature of the assets;
  + The nature of the business of the chargor; and
  + The level of flexibility and freedom the chargor will have to deal with the charged assets.

Where the chargor agrees to ‘material and significant’ restrictions on the disposal of the assets and a prohibition on the disposal of such assets in the ordinary course of business, the charge likely take effect as a fixed charge. This is on the basis that the lender (as chargee) will be retaining ‘very significant control’ over the charged assets.

Equally, if there are some careful and considered exceptions to the prohibition on disposal, this does not always mean that the charge cannot take effect as a fixed charge.

Therefore, control remains a significant factor in the determination of the charge as a fixed charge under both Spectrum and Re Avanti.

**What are the disadvantages of a floating charge for a lender?**

The borrower is free to deal with the assets subject to a floating charge. Whilst this flexibility enables a borrower to run its business day to day, the risk for the lender is the reduction of the 'pool' of assets available to it on enforcement of its security. Although the lender will benefit from certain contractual protections to mitigate against this, the lender will nonetheless prefer to take fixed charges over important assets.

Floating charges rank behind fixed charges (even those entered into after the floating charge), preferential creditors (such as employees) and the prescribed part fund.

Administrator/liquidator fees, costs and expenses are taken out of floating charge assets (including any tax liability on capital gains arising from disposals made by the administrator in the course of administration.

It is subject to more stringent avoidance rules as in certain circumstances floating charges are void if the borrower enters into liquidation or administration.

A floating charge may not be recognised in other jurisdictions.

**What are the advantages of a floating charge for a lender?**

The lender obtains security, but the borrower retains flexibility to run its business day to day as it is able to dispose of assets subject to a floating charge in the ordinary course of its trading.

Provided the floating charge together with any other security the lender holds over the borrower's assets is over all or substantially all  of the assets of the borrower, a lender will be a holder of a '**qualifying floating charge'**giving it the right to appoint an administrator out of court - see next slide.

Historically, a lender with a floating charge could appoint an administrative receiver with wide-ranging powers to manage the borrower and sell the borrower's assets to repay the lender.

However, for floating charges **created on or after 15 September 2003**, the lender will only be able to appoint an administrative receiver if the charge falls into one of the **‘limited exceptions’**(e.g., the floating charge was created in relation to certain project financing or capital markets transactions). The detail of these exceptions is outside the scope of this knowledge stream.

Therefore, if the floating charge was created on or after 15 September 2003 and **does not fall within one of the ‘limited exceptions’**, the lender can **no longer** appoint an administrative receiver, but as a holder of a ‘**qualifying floating charge’** (as defined below) such a lender has the power to appoint its own choice of administrator by using an out-of-court procedure, which is quicker and cheaper than the court-based process of appointing an administrator.

A ‘**qualifying floating charge**’ is one which fulfils the requirements of paragraph 14 of Schedule B1 to the Insolvency Act 1986.

Essentially, this means that (i) a floating charge, which together with any other security the lender holds over the company's assets is over the whole or substantially the whole of the company’s assets and (ii) the document creating the floating charge must state that paragraph 14 applies or purport to grant to the lender the power to appoint an administrator.

**Mortgages**

**What is a mortgage?**

A mortgage is a transfer of ownership of an asset to the lender.

In the case of a legal mortgage, it involves the transfer of legal ownership. In the case of an equitable mortgage, it involves the transfer of beneficial ownership.

With a legal mortgage the lender then becomes the owner of the asset, subject to a right of redemption following repayment by the borrower.

[Diagram:

“Legal mortgage” arrow to “Legal Ownership”

Equitable Mortgage “arrow to” Beneficial Ownership]

**Legal mortgage**

A legal mortgage involves a transfer of legal title to an asset to the lender, subject to:

* an obligation on the lender to transfer the asset back to the borrower on repayment of the loan (known as the ‘equity of redemption’); and
* a right to take possession of and sell the asset on default.

Assets which may be subject to a legal mortgage include ships and aircraft. Provided the mortgage is created by deed, the lender will enjoy a power of sale pursuant to s. 101 Law of Property Act 1925 (the **'LPA 1925’**).

A transfer of legal title to certain assets (such as shares) bring greater administrative burdens and potential liabilities, so an equitable mortgage or fixed charge may be preferable, as there is no transfer of legal title on their creation. Taking security over shares is considered further later on in these slides.

Legal mortgages cannot be taken over future property- the asset must be owned by the chargor when the security is created. Also, legal mortgages can only be created over legal interests in assets (not equitable interests).

**Mortgages over land**

Under the LPA 1925, a legal mortgage over land can only be created by way of a “charge by deed expressed to be by way of legal mortgage” (s. 87 LPA 1925). It does not transfer legal title to the asset but gives the secured creditor similar rights. Crucially, the lender benefits from a power of sale over the land.

In practice this may be referred to as ‘a charge by way of legal mortgage’, ‘legal mortgage’ or a ‘first legal mortgage’. In addition to registration at Companies House, charges by way of legal mortgage should also be perfected by registering at the Land Registry in order to obtain priority over subsequently created security interest.

As it is not possible to create a charge by way of legal mortgage over land acquired after the date of the security document (a debenture) then a lender will usually take an equitable mortgage over any future land with an assurance from the borrower that they will ‘upgrade’ the fixed charge over such land to a charge by way of legal mortgage as and when the lender requires it. This ‘upgrade’ will occur by the borrower executing a short supplemental mortgage and registering it at Companies House and the Land Registry.

**Equitable mortgages**

Equitable mortgages do not involve a transfer of legal ownership but a transfer of the beneficial interest in an asset. An equitable mortgage is created with less formality than a legal mortgage. There is no practical difference between an equitable mortgage and a fixed charge – both will give the lender a proprietary interest in the asset concerned.

A ‘bona fide’ purchaser for value without notice of an equitable mortgage would buy the asset free of the mortgage. Registration of the equitable mortgage at Companies House is therefore very important (and is a requirement pursuant to s.859A CA 2006 in any event).

This will ensure a purchaser has 'actual notice' of the equitable mortgage by searching the charges register. The law is unclear as to whether registration itself would operate as 'constructive notice' on a purchaser who hasn't carried out a search of the charges register, but further consideration of this is point outside the scope of this knowledge stream.

**The differences between mortgages, charges and charges by way of legal mortgage:**

The theoretical difference between these three types of security is that:

* a **mortgage** is the conveyance of an asset to the lender - i.e., the transfer of title (either legal or beneficial) to the asset. The lender becomes the owner of the asset subject to a right of redemption – i.e., the lender has to transfer it back to the borrower following repayment of the underlying loan.
* a **charge** gives the lender proprietary rights in the asset, but there is no transfer of title to the asset itself.
* a **charge by way of legal mortgage (applies to land only)** does not transfer title to the asset. Instead, it grants the lender the same powers, protection and remedies as if the mortgage had been created by way of a lease for a term of 3,000 years.

**Security by taking physical possession of an asset**

**(Note: these are not commonly used in debt finance transactions)**

**Pledge**

A pledge arises where a lender takes actual or constructive delivery of an asset until repayment of a debt. An example of constructive delivery is where the lender receives the keys to a safe deposit box which contains the relevant asset. No other formalities are required, but to avoid any argument that an item has merely been deposited for safekeeping, a letter of pledge or a memorandum of deposit is usually provided. There is an implied power to sell the asset if the debt is not repaid.

To be valid, the pledge must provide the lender with control of the asset. The lender taking a pledge has liability as bailee and it must keep safe custody of the asset alongside ensuring that the asset is insured.

The borrower loses possession of the asset for income-generating purposes.

**Lien**

A lien is a right to retain another’s property until that person meets an obligation such as payment for services. This is different from a pledge where an asset is delivered to and retained by a lender until a debt is repaid. The right arises automatically by operation of law and typically (although not always) involves possession of the property.

For example, where a mechanic is in possession of a car for repair they are able to retain the car until the owner has paid the repair bill.

**Assignment by way of security**

The borrower’s rights under a contract (also referred to as a ‘chose in action’) can be a valuable asset over which the lender may wish to take security. Examples of a borrower’s contractual rights against a third party include where a borrower has (i) the benefit of an insurance policy with an insurance company, or (ii) is owed interest and principal under a loan it has made, or (iii) has a valuable income-stream under a supply contract with a third-party (the contract counterparty).

The borrower can create security over the benefit of each of these arrangements in favour of a lender.

This is subject to checking first whether the consent of the counterparty is required for an assignment, or whether a contract contains a prohibition on assignment. This issue needs to be addressed before security is taken. If consent cannot be obtained, there is little point in taking the security in the first place.

Security over contractual rights is usually taken in the form of an assignment by way of security or a fixed charge – this will generally be a matter of preference for the lender.

An assignment will either be legal or equitable depending on how it is created, as discussed below.

**Difference between legal and equitable assignment**

**Legal Assignment**

If the assignment satisfies the criteria set out in s. 136 LPA 1925, it will be a **legal** assignment (or a ‘statutory assignment’) and will be equivalent to a legal mortgage in that the ownership of that right passes to the lender. However, because the assignment is only intended to serve as security, the security document will also contain a proviso for re-assignment on satisfaction of the secured obligation by the borrower.

Section 136 LPA 1925 sets out the requirements for a legal assignment. It must be:

* in writing;
* an absolute assignment (subject to a proviso to re-assign) in that the **whole** of the asset must be assigned, not just part of it;
* signed by the assignor; and
* **notified** to the original debtor/contract counterparty.

**Equitable Assignment**

An **equitable** assignment will arise if the parties intend to create an assignment, but one or more of the elements of s. 136 LPA 1925 are not satisfied. The element most likely to be missing in an assignment by way of security is notice to the original third party involved in the arrangement.  For practical purposes, it is less important whether an assignment is legal or equitable and more **important whether notice has been given.**

**Practical and commercial considerations when taking security**

The key point to bear in mind when considering the adequacy of a security package is that it is not its value at the time the security is taken which matters, but what its value would be in an enforcement situation – particularly in the event of the borrower’s insolvency. So, in considering what security to take and which other matters to consider, it is the enforcement of the security which must be uppermost in a lawyer’s mind.

**Consequently, the lender and its lawyers must consider various issues, such as:**

* if the consent of the contract counterparty is required for the assignment of a key contract, that issue needs to be addressed before the security is taken. If consent cannot be obtained, there is little point in taking the security in the first place;
* will the lender enforce security over the whole of a business by way of a share sale or an asset sale, or will the lender want the option of being able to do either - i.e., should the lender consider taking a charge over the shares of the borrower in addition to charges over the assets owned by the borrower?

Continued

**Practical and commercial considerations when taking security**

* will each secured asset retain its value? Is it a perishable item or an item which could quickly become obsolete? A lender needs to be aware of the risk of depreciation of certain assets (e.g. plant and machinery), although this in itself will not prevent a lender taking security over such assets;
* is there existing security over any asset(s)? If so, assess whether it will be possible for the borrower to grant further security over such asset(s) - i.e. will any negative pledges be triggered? Also, even if it is possible to grant further security, consider the implications of having more than one competing security over the same asset (i.e. a subsequent lender will rank below an original lender with prior security correctly created and registered);
* can the asset be sold easily? Is there a ready market for it? Can its value be ascertained? For instance, there may be no ready market for shares in a small private limited company; and

For certain assets there are further issues which need to be considered when contemplating taking security, which are discussed in the next few slides.

**Fixed charge over book debts**: It is not sufficient for the security document to describe the charge as ‘fixed’. The judgement in *Spectrum* stated  that the categorisation of whether a charge is fixed or floating depends upon the commercial nature and substance of the arrangement, not what the parties have called the charge in the security document.

* The label that the parties have given to the security may indicate the parties’ intention in this respect, but it is not conclusive. It is a question of substance over form.
* The lender needs to demonstrate sufficient control over book debts and the proceeds of their collection for there to be a fixed charge. If control is lacking, it may be re-characterised as a floating charge.
* If a fixed charge is to be taken over book debts, some controls will usually be documented in the security document. It is common for a floating charge to be taken in respect of book debts arising from the sale of goods and services.

**Security over shares:** Practical steps to take when taking security over shares include checking that:

* the directors do not have the right to refuse to register a transferee (i.e., the lender or a buyer of the shares following enforcement) in the register of members of the company; and
* pre-emption rights do not apply to a transfer of the shares on enforcement.
  + If there is a right to refuse a transfer or pre-emption rights do apply, the Articles of Association of the relevant company must be amended **before** the relevant security is granted. This type of check is done at the outset of the deal through due diligence and can be a common trainee task. The Articles of Association (with any amendments) will be one of the conditions precedent documents.

Practical steps to take when taking security over shares include checking that:

* Will the lender become a person of significant control ('PSC') (as covered in Business Law on the SQE 1 preparation course), giving rise to a registration requirement on the borrowing company's PSC Register. A company is required to request information from any legal entity it knows or reasonably believes to be a PSC required to be registered on its PSC register. If a legal entity with a relevant interest in the company (i.e. shares) fails to respond to the request, the company may issue a restrictions notice freezing the relevant interest. From a debt finance perspective, this is relevant in the context of taking security over shares. If a restrictions notice is issued, it could affect whether the security over shares can be taken, enforced or whether voting rights can be exercised.
* Will the grant of security over shares trigger a mandatory notification requirement to the Secretary of State for Business, Energy and Industrial Strategy under the National Security and Investment Act 2021.

Further checks to make include:

* Are the shares in an **un**limited liability company? In this situation, the liability of the shareholder is not limited to the nominal value of the shares but is unlimited.
* Is there any amount unpaid on the shares?
* Are there any liens over the shares?
* Does the company whose shares are mortgaged or any of its subsidiaries operate a defined benefit pension scheme? If so, the lender needs to be advised that, should the scheme be in deficit at the time, or after enforcement, of the legal mortgage, the lender may be liable for that deficit if it is ‘associated’ or ‘connected’ with the company (see below). This can be the case even if the liability is in a subsidiary of the company whose shares are mortgaged.

The strongest form of security which can be taken over shares is a **legal mortgage**.

* In order to perfect a legal mortgage over shares, the borrower will execute a stock transfer form in favour of the lender and the lender will then be registered in the register of members of the company whose shares are being charged.
* The lender will also receive share certificates in its name – in other words, the lender becomes the legal owner of those shares, subject only to the right of redemption.
* This means the lender has the right to receive notices to vote, to receive dividends, to receive bonus shares, is treated as a member of the company and can more easily, effect a quick sale of the company.

However, there are disadvantages to a lender in taking a legal mortgage of shares, namely:

* being a member of the company will involve a degree of administrative duties such as attending meetings and voting. A lender may appoint a nominee for this purpose;
* if the shares are partly paid, the lender (as new owner) will be liable for the uncalled amount;
* there is a risk to the lender of the company whose shares have been mortgaged to it becoming a subsidiary for the purposes of the CA 2006, or an associate company of the lender for the purposes of the Insolvency Act 1986;
* the risk to the lender that it becomes liable for a deficit in a defined benefit pension scheme or for environmental issues; and
* the risk to the lender that it becomes subject to the PSC regime (under Part 21A CA 2006).

Because of the disadvantages of taking a legal mortgage discussed above, a lender may choose to take an **equitable** **mortgage** or **fixed charge** over shares instead.

* In order to perfect an equitable mortgage/fixed charge, the lender will usually require the company creating the security to provide it with a signed, but undated, stock transfer form as well as the relevant share certificates.
* The charging document will generally also contain a security power of attorney. The intention is that the lender is able to date the stock transfer form and present it to the company whose shares are secured at such time as the lender wishes to become the registered holder of those shares on enforcement of the security.

**Assignment by way of security/fixed charge over contractual rights:**Where rights under a contract has been assigned, it may provide for payments to be redirected so that they are paid by the contract counterparty directly to the lender from the date of the assignment in which case clearly notice of the assignment will need to be given to the contract counterparty.

* Alternatively, the lender may be happy for payments under the contract to continue to be made to the borrower until an Event of Default or other trigger has occurred at which point notice will be served on the contract counterparty requiring payments to be re-directed to the lender.
* An unnotified assignment is not capable of being a legal assignment because it does not comply with the requirements of s. 136 LPA 1925 (mentioned  above) but more importantly not giving notice will mean that the counterparty will be entitled to: (1) make payments under the contract to the borrower; (2) set off amounts owed to it by the borrower against the payments which it owes under the contract; and (3) amend the terms of the contract by agreement with the borrower, without requiring the lender’s consent.

**Security over insurance contracts:**The lender may wish to take security over rights under insurance contracts by way of an assignment by way of security or a fixed charge. The main types of insurance contract over which a lender will take security are:

* ‘Keyman’ insurance (this covers the risk to the borrower of something happening to an individual who is key to the business); and
* buildings insurance.
* Insurance contracts are entered into on the basis of utmost good faith. If the insured misrepresented facts when entering into the contract, the policy will be void. Non-payment of premium will also invalidate the policy.
* Lenders may try to overcome these two issues with a clause in the security document and a specific agreement with the insurer that states that misrepresentation or non-payment will not invalidate the insurance policy. This is normally strongly resisted by insurers.
* Lenders will generally not want to be ‘**jointly insured**’ with the borrower, as this may increase their potential liability (e.g. they may be liable to pay the premium, and there is the risk that the lender may do something which invalidates the policy).
* Equally, being ‘**noted**’ on the insurance policy is not sufficient protection for the lender, as it will not be a party to the insurance policy and will not be able to enforce the policy directly. The best position for the lender is for it to be referred to as **“co-insured in respect of its separate rights and interests”**.This means that the cover provided is ‘composite’ (i.e., the policy contains two contracts of insurance (1) between the insurers and the borrower and (2) the insurers and the lender). If the borrower’s interest falls away – for instance as a result of the borrower having failed to disclose something relevant or in the event of the borrower’s insolvency – then the lender’s interest should still stand.
* As an absolute minimum, the lender will want to ensure that its interest is noted on the insurance policy so that the bank is notified if the policy is varied in a material way, cancelled or not renewed and the insurers are aware that the bank may be able to claim the charged insurance monies directly or that they may be held by the borrower on trust.

**Summary**

* The main types of security explored on this workstream are:
* Charges (fixed and floating)
* Mortgages (legal mortgages, equitable mortgages and mortgages over land)
* Taking physical possession of an asset (pledges and liens)
* Assignment by way of security
* Certain practical and commercial issues (applicable to all assets and specific to particular assets) also need to be considered when determining the security package for a transaction.
* Broadly, lenders are more concerned about enforceability of security rather than the value of security on creation.

**Loan transfers – methods**

This element discusses the methods of transferring a loan.

N.B Clause references and schedule references throughout this element are to the LMA Agreement.

**Methods of transfer**

Novation

Assignment / LMA assignment

Sub participation

Risk participation

**Novation**

The New Lender (NL) and the borrower accept new rights and obligations in respect of each other. Strictly speaking, the rights and obligations of Existing Lender (EL) and the borrower with respect to each other are cancelled, not transferred.

**Formalities for novation**

Whilst under common law a novation agreement is required to be executed by all the parties, the LMA Agreement overcomes this administrative burden by providing for the use of transfer certificates (see schedule 4). These are effectively short-form novation agreements which are effective on execution by the Agent, EL and NL only - the borrower’s signature is not required, as it will have agreed in the loan agreement to the use of transfer certificates instead of a full novation agreement. NB: The Agent is only obliged to execute the transfer certificate once it has completed all necessary ‘know your customer’ checks in respect of NL (see clause 30.6(b)).

A copy of the executed transfer certificate will be sent to the borrower by the Agent as soon as reasonably practicable after execution (clause 30.8).

A fee will be paid by the NL to the Agent to cover the administrative work which the Agent must undertake in connection with the novation (clause 30.4).

The consent to the use of transfer certificates is NOT consent to the transfer to NL itself. Consent to the identity of NL as transferee is a separate consent which may still be required depending on the terms of the loan agreement and the identity of NL (second option in clause 30.2(a)).

Since novation involves the cancellation of the existing loan agreement and its replacement with a new one, any existing security for the loan granted to EL will be discharged and new security will need to be granted to NL.

This can cause problems for NL as it will rank below any prior granted security over the borrower’s assets and the time periods relating to when a liquidator or administrator may challenge the security as a transaction at an undervalue or preference under ss. 238 and 239 Insolvency Act 1986 or when a floating charge is avoided under s.245 Insolvency Act 1986 are restarted. These are known as security ‘hardening periods’.

For this reason, any security will commonly be held by a security trustee for the benefit of all the lenders from time to time. When the loan is transferred by novation, the security trustee simply holds the security for the benefit of NL rather than EL, and no new security is needed as the existing security rights will transfer automatically to NL. However, this approach may not be effective when the secured assets are located in overseas jurisdictions which do not recognise the concept of a trust.

**Advantages of novation**

Since novation involves the cancellation of the loan agreement between EL and the borrower, it results in the **complete transfer of risk** sometimes referred to as a ‘**clean break**’. All the terms to which EL is subject, both **rights and obligations**, are transferred to NL. Similarly, as the new agreement has the same terms and conditions as the old one, NL will have the **benefit of all of the terms** of the original loan agreement.

EL no longer has any non-payment risk as NL will put **EL in funds** for the principal amount novated at the time of novation. However, the price paid by NL may not be the exact principal amount; instead, it will be an amount agreed between the parties.

As novation transfers obligations and rights, it will **remove** the loan (including any undrawn amounts) from **EL’s balance sheet.**

Novation can be used to transfer **all or part** of a loan.

Assuming the loan agreement provides for the use of transfer certificates (i.e. it reflects the LMA Agreement), novation is a very **quick and cheap** method of transfer.

Provided a security trustee has been appointed, the **benefit of security** will be held by the **security trustee** on trustfor the benefit of the lenders from time to time. Therefore, that benefit will pass from EL to NL without the need for a separate agreement or any loss of priority or the re-starting of hardening periods.

**Disadvantages of novation**

At common law, the **consent of the borrower** is required. The borrower may consent to novation in advance under the terms of the loan agreement, but this consent may be limited to certain specified circumstances.

In the LMA Agreement, the borrower’s consent is given in advance to transfer by novation **to existing lenders and their affiliates/related funds** (an affiliate being defined as a bank in the same group of companies as EL). Therefore, **consent is only required for a novation to transferees which are not existing syndicate lenders or affiliated to existing syndicate lenders** (clause 30.2(a)(i)). Note also that the LMA Agreement provides at clause 30.2(a)(ii) that the consent of the borrower will not be required if an event of default is continuing at the time of the relevant transfer. Under clause 30.2(b) the borrower’s consent must not be unreasonably withheld or delayed and will be deemed given after 5 business days unless expressly refused within that time. NB: In some practice areas such as the leveraged loan market, a borrower will invariably control a transfer (to a greater or lesser extent).

The change of identity of the lender may trigger the **tax gross-up** or **increased** costs clauses in the loan agreement. The borrower will not want to be exposed to the risk of paying increased costs on a transfer and may refuse its consent to the identity of any NL which would entail an increase in its costs.

However, the loan agreement may provide that the borrower will not be liable for any increased costs or to gross-up interest payments as a result of the novation. This is the position taken in clause 30.3(e) (i) and (ii) of the LMA Agreement, which protects the borrower from paying increased costs arising as a consequence of the novation, except if the novation occurs in the primary syndication of the loan. Always check the loan agreement in case this provision also covers the borrower’s obligation to gross-up interest payments.

Primary syndication would include syndication before the loan agreement is signed or shortly thereafter (the secondary market is the sale of debt that occurs after primary syndication of the original loan has been completed).

Where security for the loan consists of assets located overseas, the governing law of the security will usually be the law of the asset’s location. If the security trustee structure is not effective under the local law (of particular concern in civil law jurisdictions), the effect may be that novation discharges the security. New security can be created, but this is problematic since priority will be lost and hardening periods for insolvency purposes will be re-started – not to mention the costs and time involved in creating and perfecting the new security.

EL will no longer be the lender of record. This may not be a problem, but if the main purpose of entering into the loan was to establish a relationship with the borrower the relationship may potentially be adversely impacted. This is because it won’t be possible to achieve a transfer by novation without the borrower being aware where the borrower's consent is required.

A potential NL is unlikely to be willing to enter into a novation (or any other loan transfer) without being given information about the borrower. EL will have given an express confidentiality undertaking to the borrower (clause 43). However, clause 43.2(b)(ii) and (A) allows EL to disclose information about the borrower to the NL in contemplation of a loan transfer provided the NL enters into a confidentiality undertaking with the EL.

**Assignment**

Rather than creating a new agreement an assignment involves the transfer of EL's existing rights to the NL. Only EL's rights will be transferred - obligations cannot be assigned.

The LMA Agreement contractually circumvents the main disadvantage of assignment (namely that only the benefits and not the burdens can be assigned).

**We focus on LMA Assignment in this knowledge stream**, as this is more commonly used in practice. However, you do need to understand how an assignment works at law in order to appreciate how the LMA assignment differs.

At common law, only EL’s rights will be transferred – **obligations cannot be assigned**.

**Formalities of Assignment**

Only EL and NL need be party to the **assignment agreement**.

At law consent of the borrower is not required for an assignment to take place, although the underlying agreement may include restrictions relating to assignment, such as need to get the borrower's consent.

The assignment will only be a **legal assignment** if the requirements of **s.136(1) Law of Property Act 1925** are satisfied. These requirements are that the assignment must be: (1) absolute – this means that the assignment must be for the whole of EL’s part of the debt; (2) in writing and signed by EL; and (3) notified to the borrower (NB: only notice is required, not consent). A legal assignment will transfer full legal and beneficial title to the loan to the transferee.

An assignment which does not satisfy all the requirements of s.136 will be an **equitable** assignment, under which only a beneficial interest passes.

It is important for NL that**notice** is givento the borrower in order for there to be a legal assignment. If notice is not given, NL is exposed to increased risk as the borrower will be entitled to: (1) make payments to EL rather than NL; (2) set off amounts owed to it by EL against the payments which it owes to NL on the loan; and (3) amend the terms of the loan by agreement with EL, without requiring NL’s consent. In addition, assignments generally rank in priority in accordance with the date that notice is given to the borrower (by the rule in *Dearle v Hall*). **In practice, giving notice of the assignment is more important than whether the assignment is legal or equitable (which often is simply a case of whether all or only part of the loan is being assigned).**

To transfer the benefit of any security a **separate security assignment** may need to be signed in addition to the assignment agreement. If security is located outside England and Wales local advice must be sought but it may be that, in civil jurisdictions, assignment avoids the problems related to security which we considered in relation to novation.

**Advantages of legal assignment**

The NL will put the EL in funds for the drawn down amount that has been assigned. This will be the price that is agreed between the parties (whether the existing principal amount or a lower amount, for example, with a non-performing loan).

A legal assignment, or an equitable assignment that is notified to the borrower, will generally remove the drawn down amounts from EL’s balance sheet and its capital adequacy requirements.

The consent of the borrower is not usually needed and the assignment agreement need only be signed by EL and NL.

**Disadvantages of legal assignment**

At law, assignment transfers rights, not obligations. EL will therefore still be required to provide future funding to the borrower, e.g., under an RCF or a term loan that is not yet fully drawn. Assignment is therefore not an effective transfer method if there are outstanding lending obligations. This is the main reason why, in practice, loans are rarely transferred by legal assignment.

Serious issues arise for NL if notice of the assignment is not given to the borrower - one key point is that if the borrower is not notified of the assignment, it is entitled to continue to make payments to EL. This means that NL is reliant on EL to pass on principal and interest to it, and so is taking a double credit risk first, on the borrower making payments to the EL and secondly, on EL passing on the payments to the NL It is only possible to avoid disclosing an assignment to the borrower if NL is prepared to accept these consequences. Note that notice is a separate requirement from borrower consent to the assignment and a requirement for consent (see above) would mean the borrower becomes aware of the assignment anyway.

**LMA assignment**

The LMA Agreement provides a procedure for assignment (clause 30.7) which supplements the common law position. It provides a pro forma assignment agreement (Schedule 5) and contemplates **the release and assumption of obligations as well as the assignment of rights,** and in this way the main disadvantage of a legal assignment is avoided.

Under the LMA Agreement the parties, in addition to assigning rights, make a **contractual agreement** that EL releases its obligations and the NL assumes equivalent obligations. For this reason, an LMA Assignment is a hybrid which is more similar to a novation than a legal assignment.

One important point to note regarding the formalities of execution of an LMA Assignment is that the LMA form of assignment agreement requires execution by EL and NL with the Agent countersigning by way of confirmation. It needs to be addressed to the Agent and the Company (i.e. the borrower). As such the **borrower will receive a copy of the executed assignment agreement** (a copy will be sent to the borrower by the Agent as soon as reasonably practicable after execution – clause 30.8 of the LMA Agreement). Receipt of the assignment agreement**will represent actual notice** to the borrower of the assignment, meaning that NL will become 'lender of record' and avoid any double credit risk that may arise if payments ultimately due to it were to be made first to the EL.

The common law position regarding consent is also varied under the LMA Agreement. Under the second option in clause 30.2(a)(i), the borrower’s consent is required for assignments to lenders which are not existing syndicate members or affiliated to existing syndicate members. This means that the same consent provisions apply on LMA Assignment as they do to LMA novation. In the same way as novation, the LMA provides at clause 30.2(a)(ii) that the borrower’s right to veto an assignment to the NL will be overridden if an event of default is continuing at the time of the relevant assignment.

NL will pay a fee to the Agent to cover the administrative work which the Agent must undertake in connection with the assignment – see clause 30.4 of the LMA Agreement.

As the LMA Assignment is more similar to a novation you may be wondering why an EL would ever opt to use an assignment agreement (Schedule 5) rather than a transfer certificate (Schedule 4). The answer to that question is that in the vast majority of transfers a novation will be used as the preferred method since it is more straightforward and does not require a separate security assignment. An assignment agreement will usually only be used where security has been granted over assets located in a civil jurisdiction which does not recognise the concept of a security trust. In this situation, local lawyers would need to be instructed to ensure that the LMA provisions whereby the NL assumes obligations would be enforceable under local law and of course to ensure that any local law formalities were followed in preparing and executing the separate security assignment.

**Sub-participation**

Sub-participation does not involve any transfer of rights or obligations from EL to NL. Instead, EL and NL enter into a separate agreement (a **sub-participation agreement**) creating new rights and obligations between EL and NL. The intention behind a sub-participation is to transfer the economic interest/risk associated with the loan, while leaving the relationship between the EL and the borrower unaffected. Sub-participations can be entered into on a funded or risk basis

In a **funded** participation, the NL agrees to pay the EL the principal amount of the loan to be participated (which can be all or part of EL's participation). The EL is then obliged to pass on payments of interest and principal relating to the participated part of the loan when EL receives those amounts from the borrower. The credit risk in relation to the loan therefore passes to the NL.

**Formalities of funded participation**

A sub-participation agreement between EL and NL is required. The borrower will not be a party to the agreement, and indeed may not even be aware that the sub-participation has taken place. The LMA produces a standard form of sub-participation agreement.

If EL is required to provide future funding to the borrower (i.e. under an RCF or a term loan with tranches that have not yet been drawn down), a sub-participation agreement can provide for NL to place EL in funds as and when those further advances are made by EL.

As EL remains the lender of record, it will remain entitled to the benefit of any **security.** It is **not** normal practice for EL to assign the security rights to NL. Instead, NL will rely upon EL exercising its rights under the security on its behalf.

The LMA sub-participation agreement provides that EL must pay over to NL pro rata to NL’s participation the relevant proportion of interest and principal including the proceeds from a realisation of security held by EL, which EL receives from the borrower. This must be done ‘without material delay’, If not, EL will be in breach of contract.

**Advantages of funded participation**

As a matter of law, **consent is generally not required** for sub-participation, although it is possible for the loan agreement to vary this position and require the borrower’s consent to sub-participation.

Unlike novation or assignment, with sub-participation EL **remains the lender of record**. There is no need for the borrower even to be informed that the sub-participation has taken place. This may be important if EL wishes to protect itself against the risk of the borrower not repaying, without damaging its relationship with the borrower.

Once NL has paid the drawn down amounts to EL (putting **EL ‘in funds’ for the drawn down amounts**), **EL’s risk is fully removed in respect of those drawn down amounts**. As we saw above, if the borrower fails to pay any part of the principal or interest to EL, EL is excused from paying the unpaid agreed amount to NL.

If EL still has a **commitment to make further advances** to the borrower under the terms of the original agreement, then EL still bears the risk of those future advances until they too are requested by the borrower and EL has been ‘put in funds’ by NL in respect of those further advances.

Sub-participation **removes risk in relation to drawn down amounts** which will satisfy EL’s internal credit committee that the risk has been transferred. Risk relating to undrawn amounts will only be removed once EL is funded by NL.

Until NL funds these undrawn amounts, EL takes a credit risk on NL which may or may not satisfy EL’s internal credit committee from an internal risk perspective.

**Disadvantages of funded participation**

**Confidentiality**. As mentioned earlier, NL is unlikely to be willing to accept a sub-participation without being given detailed information about the borrower and EL will have given an express confidentiality undertaking to the borrower. However, clause 43.2(b)(ii) and (A) allows disclosure of information to potential sub-participants subject to obtaining a confidentiality undertaking from the potential NL. Without this provision, the need to obtain the borrower’s consent to sharing information with the potential NL will negate the benefit of not having to obtain consent to the sub-participation itself.

**Rescheduling risk**. As there are two parties involved, provision needs to be made in the sub-participation agreement for which party will bear the rescheduling risk (i.e., EL having to deal with the borrower in financial difficulty after it has executed the loan transfer). Usually, NL will bear the risk e.g., it will be the EL which must conduct the negotiations with the borrower as the borrower is likely to be unaware of the existence of the NL. However, if EL has sub-participated its entire interest in the loan, EL may agree not to make certain substantial changes to the loan agreement without NL’s consent. If EL does find itself in negotiations with the borrower and unable to agree to amendments without NL’s consent, the existence of the sub-participation may become apparent to the borrower, and this may have an impact on its relationship with EL.

Because EL is relying on NL to put it in funds, it remains exposed to the risk of NL defaulting until it receives the funds. This is particularly an issue in relation to EL’s obligation to lend further amounts. Although EL can sub-participate this obligation by requiring NL to fund any future drawdown requested by the borrower, until actually put in funds, EL will remain exposed to NL for the amount of its undrawn commitments.

As EL remains the lender of record, the benefit of the terms of the agreement are not transferred to NL. NL is not therefore entitled to benefit from the gross-up clause or the increased costs clause.

NL is exposed to the double credit risk of both the borrower and EL. If either the borrower defaults and fails to pay EL, or EL defaults and fails to pass on the amount received, NL will not receive the full principal and interest due. NL has no contractual relationship with the borrower, and therefore, if there is a non-payment, NL must rely on EL to pursue the borrower on its’ behalf.

**Risk participation**

As with funded participation, EL and NL enter into a separate agreement. However, in the case of risk participation, the agreement provides that NL will **only pay EL to the extent that the borrower does not pay the amount it owes to EL in full**.

This works something like a **guarantee or insurance**, in the sense that NL agrees to make good any amount which the borrower fails to pay to EL. EL will pay NL a fee in return for entering into the agreement. This type of participation is sometimes commercially referred to as an **unfunded participation**.

**Formalities of risk participation**

A **risk participation agreement** between EL and NL is required. As with funded participation, the borrower will not be a party to the agreement and may not even be aware that the risk participation has taken place. The LMA produces a standard form of risk participation agreement. As with the LMA sub-participation agreement, NL does not have any direct contractual relationship with the borrower. A risk participation operates as a form of guarantee – the NL does not provide any funds upfront but instead is obliged to fund the EL following the occurrence of specified triggers (for example, default by the borrower), in exchange for payment of a fee by EL.

**Security**. Risk participation does not pass the benefit of any security to NL. Instead, it must rely on EL enforcing any rights, including the right to enforce security against the borrower following an event of default. If EL recovers any monies as a result, it is under a duty in the LMA risk participation agreement to forward the monies pro rata to NL promptly, in a similar way to the LMA funded participation agreement.

**Advantages of risk participation**

As with sub-participation, risk participation can usually be entered into **without the borrower’s consent** or even its knowledge.

With risk participation, **EL remains the lender of record**, and can therefore off-load risk without revealing the fact to the borrower, thereby preserving its relationship with the borrower.

Although the loan will remain on EL’s balance sheet (see below) a risk participation may still be enough to satisfy EL’s internal credit committee if their objective is risk management, as the ‘guarantee’ or ‘insurance’ element makes the loan potentially safer (the assumption being that NL is a better credit risk than the borrower).

**Disadvantages of risk participation**

With risk participation, NL pays nothing to EL unless and until the borrower defaults. The EL does not therefore receive funds to invest in other projects.

Because EL is not put in funds, it does not know for certain until the borrower defaults whether NL will pay the defaulted sum in accordance with the risk participation agreement.

This means that risk participation does not get rid of EL’s risk altogether, but simply replaces an exposure to the borrower with an exposure to NL. The loan is still on EL’s balance sheet and included in their capital adequacy requirements.

**Summary**

Methods of transferring a loan include:

· Novation - the NL and the borrower agree with EL that NL will assume identical rights and obligations to those of EL under the loan agreement.

· At law an assignment involves the transfer of EL’s existing rights to NL, but not obligations. An LMA assignment circumvents this and operates more like a novation.

· Sub-participation - EL and NL enter into a separate agreement (a sub-participation agreement) under which NL agrees to pay EL an amount equivalent to the principal amount (or lower for non-performing loans) of the loan being transferred, in return for EL passing on payments of principal and interest if, and when, it receives them from the borrower.

· Risk participation - EL and NL enter into a separate agreement. However, in the case of risk participation, the agreement provides that NL will only pay EL to the extent that the borrower does not pay the amount it owes to EL in full.

**Loan Transfers – objectives and practicalities**

Loan has become too risky

To release capital for new venture

Loan is non-performing

Loan may no longer suit bank portfolio

Loan may have been put together quickly through a small group of lenders with the intention of syndication post-closing

**Why transfer a loan?**

**Risk Management**

Each bank will have its own credit rules, usually applied by an **internal**

**Regulation (capital adequacy)**

Banks are also subject to external controls on the risk they can assume. The capital adequacy rules are designed to protect the bank’s creditors by ensuring that the bank has sufficient capital to absorb the likely losses from borrowers defaulting on their loans. Under the Basel accords, implemented in the UK by various pieces of legislation, the amount of capital which banks must retain as a cushion has significantly increased. This means that banks need to actively manage their loan portfolios and some lenders have been forced to limit the number of loans on their balance sheet in order to comply with more stringent capital adequacy requirements.

**Portfolio management – prestige and profit**

Banks keep their loan portfolios under continuous review to make sure they have the right balance of risk and return.

For example, a bank may find that its existing loans are not sufficiently profitable. In that case, it may wish to sell those existing loans and free up the capital to invest in more profitable opportunities elsewhere.

In some cases, a bank may even take part in a loan with no intention of remaining involved after signing. It may be that the bank wants the prestige of the initial involvement or the initial agency and/or arrangement fees but does not consider the interest rate on the loan itself to be high enough to make it worth keeping the loan on its books. In that case, it may participate in the loan at signing but then transfer the loan afterwards, freeing up capital to allow it to participate in new loans.

Sometimes, a bank may even be able to make a profit on the sale of a loan. For example, when interest rates fall, it may be possible to sell a loan with a high fixed rate for more than its face value.

**Non-performing loans – ‘distressed debt’**

If it becomes apparent that a borrower is in difficulty, a lender may choose to cut its losses and sell the loan. Naturally, given the increased risk of the borrower defaulting, it is unlikely that the bank will be able to sell the loan for its full face value. Instead, it will sell the loan at a discount, often to specialist firms which buy and manage these loans in the hope of eventually being repaid more by the borrower than they had to pay to the original lender to buy the loan. Loans bought and sold in this way are often referred to as ‘distressed debt.’

**Realising capital/improving liquidity**

A bank may need to free up capital which it has tied up in long-term loans in order to improve its liquidity. This will enable a bank to use that money to invest in new profitable lending opportunities. This may give the bank a greater return especially if the loan they are transferring is relatively unprofitable.

**Primary Syndication**

You have already seen that a group of banks can provide a syndicated loan by signing up to a single facility agreement under which each bank is severally responsible for making loans to the borrower up to the amount of its commitment. However, where the amount borrowed is very large or the time available very short, it may not be practicable for a complete syndicate to be put together in time for signing.

In that case, the arranger (or arrangers if there are more than one) may have been required to fund the entire loan (or substantially more than it originally intended its commitment to be) and so will use loan transfers as a method of reducing its exposure down to a level which it originally envisaged having. If this is done immediately after signing, or shortly after, this will still come within the idea of ‘primary syndication.’

There are various methods to transfer a loan. To be sure of choosing the most appropriate method, you need to know what the existing lender (‘**EL**’) is trying to achieve by selling the loan to the new lender (‘**NL**’).

**Objectives of transferring a loan**

**Non-payment risk**

If the EL’s aim is simply to transfer the risk of non-payment, there is more than one way of doing this. Some methods of transfer (namely risk-participation and credit default swaps) will simply replace the risk of non-payment by the borrower with a risk of non-payment by NL rather than removing the risk of non-payment altogether. Whether this is acceptable will depend on the lender’s objective – for example, if it has concerns about a specific borrower defaulting then ‘swapping’ the risk of non-payment of that borrower for that of the NL may well meet EL’s objective. However, if it has a concern about its exposure to a particular country then a transfer to an NL located in the same country as the borrower may not meet EL’s objective.

**Availability of funds**

Sometimes, the reason behind the transfer of a loan will be to make capital available for investing in new projects. If so, it is important to ensure that the transfer of the loan is done in such a way that EL is ‘put in funds’ i.e., it receives from NL the principal amount of the loan that has been drawndown and is being transferred.

**Obligation to lend further amounts**

Under an RCF (or a term loan with undrawn tranches) EL may still have obligations to make further advances. Under English law, it is only possible to assign the benefit (rights) not the burden (obligations) of a contract. It is therefore necessary to ensure that transfers of all or part of these types of loans are effected in a way as to ensure that both the rights and obligations are assumed by NL and which does not leave EL at risk for the amounts which it has yet to lend.

**Regulatory concerns (capital adequacy)**

EL may need to reduce the amount of loans which it has made because it has issues meeting capital adequacy requirements. In this situation EL will need to ensure that the method of transfer used is one which will effectively take the loan ‘off balance sheet’ for its own capital adequacy purposes (and move it to NL’s balance sheet) which broadly means that EL cannot retain any on-going risk or liability with regard to the loan (or part thereof).

**‘Rescheduling risk’** refers to the risk of EL having to deal with a borrower in financial difficulty after it has executed a loan transfer.

If, after the loan is transferred, the borrower gets into difficulties, EL may be forced to negotiate with the borrower to find a way to help it get back on its feet. For example, EL may need to provide additional funding, renegotiate repayment terms or allow a deferral of payment. Any such action will mean that EL does not free itself from the administrative burden associated with the loan and ultimately may have an impact on the return from the loan. It is important to determine whether EL wishes to bear this risk or pass it to NL.

**Practical issues to consider**

**Confidentiality -** no bank is likely to be willing to purchase a loan without first getting enough information about the borrower to determine its credit risk. EL will of course have this information, but EL is subject to the banker’s common law duty of confidentiality towards its customer. In addition, in the LMA syndicated facility agreement (the ‘**LMA Agreement**’), the EL will have given an express confidentiality undertaking to the borrower (clause 43). This means that EL may not be able to release confidential information about the borrower to a prospective NL without the consent of the borrower.

If the borrower’s consent is required for the loan transfer anyway, and such consent is given, getting the borrower's consent to the passing of confidential information should not be problematic. However, if the borrower’s consent is not required for the transfer itself, this restriction on passing on confidential information without the borrower’s consent negates the benefit of not requiring the borrower’s consent for the transfer.

To avoid this problem, the LMA Agreement does allow the disclosure of such confidential information as the EL considers appropriate in the case of transfers, or potential transfers (clause 43.2(b)(i) &(ii)). This is subject to NL entering into a back-to-back confidentiality undertaking (clause 43.2(b)(A)). The EL will want to check that this provision appears in the loan agreement, so that it is not in breach of its confidentiality obligations when it provides confidential information to a prospective NL.

**Borrower’s consent –** is the borrower’s consent required to the transfer to the NL? If so, the borrower may prevent the transfer by refusing its consent. This is particularly relevant if the transfer means the loan would become more expensive for the borrower. For example, it is unlikely that a borrower would consent to a transfer if, as a result, the increased costs or tax gross-up clauses would be triggered.

**Benefit of terms –** it will be important to NL to know whether it can take the benefit of all the terms contained in the original loan agreement (in particular, terms such as the gross-up clause and the increased costs clause). This may depend on the terms of the agreement and the method of transfer chosen.

**Secured loan–** if a loan is secured, this will influence the method of transfer chosen as security is dealt with differently under the various methods of transfer.

**Relationship –** it may be important for EL to remain the ‘**lender of record**’ by which we mean the lender which the borrower deals with day to day. For example, if EL’s main purpose in entering into the loan in the first place was to establish a relationship with the borrower, EL is likely to want to remain the lender of record, even if it transfers the loan behind the scenes. Some of the loan transfer methods enable EL to do this, but not all. Some lenders may agree to retain a certain minimum level of debt in order to preserve the relationship. This will reassure the borrower that the EL will remain a part of the borrower’s financing arrangements.

**Loan transfers: objectives and practicalities-Summary**

· There are many reasons why a loan may be transferred, including when the loan is non-performing, if the loan no longer suits a bank’s portfolio, or if the bank wishes to free up capital.

· To advise on the most appropriate transfer method, it is important to understand what the bank's objectives are in transferring a loan, for example is it to remove non-payment risk, raise further capital or remove loan from the balance sheet to ensure compliance with capital adequacy rules.

· Practical implications of loan transfer methods need to be considered, such as:

o Is the borrower's consent needed?

o Will the relationship between bank and borrower be affected?

o Are there any confidentiality issues?

o Will the benefit of all terms of the loan be transferred?

o If a secured loan, what happens to the security?

**Introduction to bonds**

This element is an introduction to raising funds through a bond issue.

**What are** **Bonds?**

A bond is a security that is issued in connection with a borrowing arrangement. It is effectively an ‘IOU’: a loan for a specific term, repayable on a specific date (the**maturity date**) and usually paying interest.

The borrower (referred to as the **issuer**) issues (sells) a bond to a lender (the **investor** or **bondholder**) in return for money. On **maturity** (when the bond term has elapsed) the issuer will pay the **nominal value** or **principal amount** (see below for definition) to the investor who holds the bond at that time. The issuer will also, in most cases, pay interest (the **coupon**) annually or semi-annually to the bondholder over the life of the bond.

The terms of the bond determining such matters as the maturity date, interest etc. will be set out on the bond certificate and in an offering document for the investor to see. So, much like a loan, the issuer can include any terms it wishes, subject to what the market will accept to buy.

A bond is a **form of debt which can be traded** (bought and sold) in the capital markets.

The bond is effectively a **debt obligation represented by a certificate**, also referred to as a debt security.

**Key elements of bonds and terminology**

‘**Nominal/par/face/redemption value/principal amount**’ – each of these terms are used interchangeably to mean the amount repayable to the bondholder on maturity. Historically, this amount would have been stated on the individual bearer bond certificates but note that (see under **coupon** below) definitive bonds are now rarely issued.

**‘Maturity/redemption’** - the maturity or final redemption date is the date on which the issuer must pay back the principal amount borrowed. The bond terms may include provisions allowing the issuer to redeem, or the investor to require redemption of, the bond earlier than the final redemption date. The date on which this occurs is known as the redemption date. Some bonds may not have any fixed final redemption date at all. These are called undated or perpetual bonds. The investor will receive interest every year and can only get the principal back by selling the bond to another investor or if the issuer decides to redeem the bond.

**‘Interest/coupon’** -throughout the life of the bond the issuer will make payments of interest in relation to specified interest periods (usually annual or semi-annual payments). These payments are also known as coupon payments. The interest payable is usually expressed as a percentage of the nominal value. The word coupon is used to mean interest. This is because, historically, when bearer bonds (as opposed to registered bonds) were in definitive form (i.e. separate certificates representing each bond) as opposed to global form (i.e. a single document evidencing the entire bond issue) , in order to be paid interest, the investor would have to detach a coupon from the bond certificate and present it to the issuer or the issuer’s paying agent to obtain payment of the interest. However definitive bonds are now rarely used and issuing bonds in global form is the more usual route.

The distinction between bearer and registered bonds and between definitive bonds and global bonds is explored further in the next element.

**‘Marketability’ –** this relates to how easily/readily a bond can be bought and sold on the international debt capital markets. This is a fundamental concept as the marketability of bonds ensures that bonds are attractive to investors since they know they can easily realise (sell) their investment. This makes bonds a comparatively low risk and attractive investment, which in turn allows companies to raise finance more easily while paying a relatively low interest rate. When bonds are highly marketable, this makes markets very liquid. To have a highly liquid market there must be a high trading volume and a high number of debt securities.

**‘Unsecured’** - bonds, and in particular eurobonds, are not usually secured. This is market practice. Investors rely on pari passu ranking and negative pledge undertakings in the bond terms for protection. This said, secured high yield bonds have become more prevalent as the volume of leveraged finance has grown in recent years.

**'Quoted eurobond exemption'**- provided the bonds are listed on a recognised stock exchange (which includes the London Stock Exchange), the quoted eurobond exemption from UK withholding tax will apply. This exemption allows a UK issuer to pay gross interest on the bonds.

**Who issues and buys bonds?**

**Issuers**

· Corporate issuers

· Governments

· Local municipalities

· Supranational organisations

· Banks

· Public bodies

· Special purpose vehicles (SPVs)

**Investors (Lenders)**

The first purchasers of the bonds (on the primary market) will be the banks underwriting the bond issue. The bonds will then be sold on the secondary market to other banks, financial institutions such as insurance companies and pension funds and sometimes high net worth individuals. However, we are all indirect participants as the financial institutions (e.g. pension funds, ISA managers, and insurance companies) use funds received from individuals to buy bonds.

Investors can either keep (hold) the bond until the due date or sell it (trade) to other investors on the capital markets to realise their investment earlier than the maturity date.

**Why issue and raise finance through bonds?**

**Potential number of investors much greater as not limited to banks and others willing to hold loans:**

· The globalisation of the capital markets allows issuers to have direct access to a very large and diverse pool of funds both in terms of currencies and types of investors (including institutional investors such as insurance companies and pension funds).

· The minimum denomination of securities which can be issued is frequently smaller than the smallest participation which can be taken in a syndicated loan. This increases the number of investors that can hold bonds.

· Issuers with large financing needs are more likely to obtain the required amounts.

**Lower financing costs:**

· The broader investor base mentioned above means the risk associated with a particular bond issue is spread out over a wide number of investors. As the interest paid by a borrower to an investor is directly linked to the risk that the investor takes, the lower the risk, the lower the interest. Therefore, bonds can provide cheaper financing for the borrower.

· Bonds are treated more favourably for capital adequacy purposes.

· Bonds are readily tradeable through international clearing systems. Although loan agreements may allow banks to transfer their loan participations to other banks, there is limited secondary trading. Since bonds are easily tradeable, investors know that they can realise their investment easily without having to wait until the maturity date. This reduces the investment risk for them and, as a result, the interest paid by the issuer is lower.

**More flexibility**

Choice of currency/type of investor: since the capital markets are truly international, if it is cheaper to borrow in a particular currency, the issuer can do so even if it does not need that currency. It can then enter into a swap agreement with a bank to obtain the currency it needs. Also, it does not need to tailor its borrowing terms to appeal to banks, as there are many other types of investors in the capital markets. In particular:

Bonds have less onerous covenants: traditionally, bond terms have imposed less stringent undertakings and financial covenants on the borrower than loan agreements have. **This is for two main reasons:**

· historically, the companies that issued bonds were **investment grade** i.e. carrying a low risk of default; and

· since investors are all over the world and difficult to trace, it would be difficult for issuers to obtain waivers as needed. As a result, **undertakings and covenants cannot be too restrictive** in a bond issue.

Bonds have more flexible terms: market size and the variety of investors means that size and maturity of debt can be more varied than in most commercial loans. In particular, capital market debt can often be borrowed for longer periods and at fixed rates of interest.

**Disadvantages of raising finance through bonds**

**Credit rating -** bond markets are generally only accessible to companies with a good credit rating. This precludes many potential issuers because investors will be more willing to invest in a company with a good credit history and reputation. However there has been a growth in high yield bonds (these are bonds that are issued by companies with non-investment grade ratings).

**More public disclosure and publicity -** there is far more public disclosure and publicity in relation to a bond issue (although issues are often privately placed) compared to a syndicated loan. This is one reason why acquisition finance is generally raised initially through a loan even if that loan is subsequently refinanced via a corporate bond issue, as one company intending to acquire another will need confidentiality.

**More regulation –** most eurobonds (referred to later) are listed and this means that there is much more regulation (in terms of disclosure requirements and continuing obligations) than in the case of loans.

**Higher transaction cost -** initial transaction costs tend to be higher in bond issues as there are more parties, more documents and more regulatory requirements involved.

**Timing: longer to put in place –** the more parties involved, documents to be drafted and regulations with which to comply, the longer the bond issue can take. Note there are significant time savings in the case of a bond issued under a euro medium-term note programme (known as an EMTN programme).

**Relationship with investors -** as the number of investors in a loan (the lending syndicate) is generally smaller than in the case of bonds, the borrower is more likely to be able to maintain a relationship with its investors in a loan context. This can be extremely beneficial for a company that needs further funds quickly or that needs to obtain a waiver. It is much more difficult to communicate with investors on the capital markets, and even more so to obtain a quick and effective response to satisfy the concerns of the borrower.

**Renegotiation of terms -** with a loan it is possible to negotiate with the lenders if the borrower finds itself in financial difficulties. With bonds, it is unlikely the issuer will even know the identity of the investors. Renegotiating the terms of a bond is therefore a lengthy, costly and uncertain process. This process can also be fraught with complex legal questions if different classes of bondholders have different interests.

**Where are bonds bought and sold?**

**Capital markets** are markets on which capital (i.e. finance) is raised. The markets are where those who want capital (the borrowers) and those who have capital (the lenders) can meet and be matched. There is no physical marketplace, rather the capital markets are made up of the global offer of cash available from investors and the global demand for cash by borrowers. Most bond trading takes place electronically, through electronic exchanges. Bond dealers and brokers buy and sell bonds over the phone or their computers. The trades are then settled through the electronic clearing systems.

**Primary/ Secondary capital markets -** the primary market is where newly issued bonds are first sold by the issuer to the first investors. The first purchasers of the bonds (on the primary market) will be the banks underwriting the bond issue. The secondary market is where all subsequent sales of bonds take place.

**Domestic market** - bonds sold on a domestic market are bonds denominated in the local currency of that market and sold to investors within that market by a local issuer. E.g. a Sterling denominated bond, issued in the UK by a UK registered company and sold to UK investors. The dominant issuer in most domestic markets will be the national government.

**Euro (international) market** -the prefix euro is not related to the EU currency. It is linked to the concept of eurocurrencies. A eurocurrency is a currency held outside of its country of origin. For example, euroyen is Yen held outside Japan, eurodollars are US Dollars held outside the US etc. The prefix euro is now synonymous with international. Therefore, a eurobond is a bond targeted at the international market either because it is:

i) a bond denominated in a eurocurrency i.e. a currency other than that of the country of issue e.g. a UK company issues a US Dollar bond; or

ii) a bond denominated in the currency of its country of issue but sold to international investors (who would be using a eurocurrency to buy the bond) e.g. a Sterling denominated bond, issued in the UK and sold to Japanese investors.

**Summary**

· A bond is a security that is issued in connection with a borrowing arrangement. It is effectively an ‘IOU’: a loan for a specific term, repayable on a specific date (the**maturity date**) and usually paying interest.

· A bond is a **form of debt which can be traded** (bought and sold) in the capital markets.

· The bond is effectively a **debt obligation represented by a certificate**, also referred to as a debt security.

· Advantages of bonds being – the potential number of investors is much greater as not limited to banks, lower financing costs and more flexibility.

· Disadvantages of bonds being – credit ratings, more regulation and taking longer to put in place.

· Bonds are bought and sold on the domestic market, the euro (international market) and primary and secondary markets.

**Types of bonds and trading of bonds**

This element discusses the different types of bonds and how bonds are traded.

The issuer will, assisted by its financial advisers, choose to issue a particular type of bond. The form it chooses will depend on its financing needs as well as what the market is most likely to find attractive. Both these factors will affect the cost of financing, both at the outset (transaction/set up costs) and also throughout the life of the bond (interest rate payable by the issuer).

**Different interest rates on the bonds**

**1. Fixed rate bonds**: the rate is fixed when the bond is issued and for the duration of the bond issue. The rate tends to be a specific percentage of the **nominal value**. See previous element for definition of this term.

**2. Floating rate bonds**: similar to a floating rate for a loan, the rate will consist of two elements. A benchmark rate, for example SONIA, plus a set percentage (the margin). The rate of interest payable on the bond will vary according to the benchmark rate at the time the interest is calculated.

**3. Variable rate bonds**: this is a hybrid between fixed and floating rate bonds. The rates will be fixed (i.e. the investor will know from the outset what rates will be payable) but will vary over time according to a pre-determined schedule. Example: 5% for the first 3 years, 4% for the next 3 years and 3% thereafter until the final redemption date.

**4. Zero-coupon bonds**: some bonds will pay no interest at all during their term. These are known as zero-coupon bonds. In order to make such zero-coupon bonds attractive, the bonds are issued (sold) at a deep discount - i.e. for an amount below their nominal value. At maturity, the full nominal value will then be paid back to the investor. As a result, the investor’s return comes from the difference between the issue price and the payment of the nominal value at maturity.

**5. Index-linked bonds**: these are bonds whose principal amount and coupon payments are linked to an index, such as inflation linked bonds which are linked to a consumer retail price index (RPI). Inflation linked bonds have their principal and coupon ‘uplifted’ to reflect inflation in line with the RPI. The investor’s return is protected against being eroded by the effects of inflation.

**6. Step-up bonds:** these are bonds where the initial fixed interest rate moves up to another pre-determined fixed rate after a given time or on occurrence of a specified event, such a change in control of the issuer or failure to meet environmental , social and governance targets specified in the terms of the bonds.

**Types of bonds**

**Equity-linked bonds:**

· **Convertible bonds**: the investor has the option (or sometimes the obligation) to hand the bond back to the issuer at a future date in exchange for shares in the issuer. At that point, the investor ceases to be a creditor of the issuer and becomes an equity holder with equity-related rights. The number of shares received for each bond which is exchanged (the**conversion ratio**) and other terms relating to the conversion will be set out in the bond terms.

· **Exchangeable bonds**:these are similar to convertible bonds. The difference is that the bonds give the investor the right to exchange its bonds into shares of a company other than the issuer (e.g. the issuer’s parent).

· **Bonds with warrants**:these are bonds that have a separate feature attached to them called a warrant. The warrant gives the holder the right to call for delivery of, for example, shares of the issuer against payment of a set price at a future date or during a specified future period. The bondholder can either (i) keep the bond and the warrant and use the warrant to acquire equity on the specified date (if any), (ii) keep the bond and sell the warrant separately to another investor, or (iii) sell both the bond and warrant together.

**Sovereign bonds**

The terms of sovereign bonds (bonds issued by governments) will differ from those of corporate issued bonds due to the identity of the issuer. Debt issues by a national government have historically been considered at the lower end of the risk spectrum (or even risk-free), as a government can employ different measures to guarantee repayment.

However, this picture has been somewhat dented by the financial crisis (in particular in the eurozone) which has seen certain governments struggle to service their debt obligations (broadly due to a combination of high existing borrowing and low economic growth), leading to default. This in turn has resulted in increases in sovereign debt borrowing costs and moves to stabilise countries at risk of default through much publicised bailouts.

Sovereign governments can also enter into voluntary restructuring arrangements with its creditors if it is at risk of defaulting.

**Notes**

There is no legal difference between 'Bonds' and 'Notes' and the terms are used interchangeably. Often:

· bonds are debt securities with a fixed rate of interest and a term of three years or more; and

· notes are either debt securities with a floating rate of interest (called floating rate notes or FRNs) or debt securities with a fixed rate of interest, but with a short maturity period, usually below three years.

However, this terminology is not used consistently in the debt capital markets. For example, on the US markets you will find 10-year notes and 30-year bonds.

Depending on its maturity date, a bond will generally be considered to be short (up to 5 years), medium (5 to 15 years) or long-term (15 years and over).

The term ‘Notes’ often describe more private issuances of debt securities such as private placement notes, notes issued as part of a private securitisation and loan notes issued in connection with a private equity-backed acquisition.

**Plain vanilla bonds**

This is jargon used in the markets to mean a bond that has no added features such as convertibility. It is a plain debt security and usually has a fixed interest rate.

**High yield bonds**

These bonds generally offer a bondholder a higher return on its investment than other types of bonds because they are deemed to be riskier. Such bonds are thought to carry a greater risk of the issuer defaulting on its payment obligations under the bonds. They are also known in the market as “junk bonds” or sub-investment grade bonds.

**Form of bonds**

**Bearer and registered** bonds:

· **Bearer bond**: means a bond is transferable by delivery. Whoever is in possession is the owner (like a banknote).

· **Registered bond**: legal ownership passes when the transferee’s name is entered into a register of bondholders held by the issuer.

For historical reasons, bonds in Europe tend to be in bearer form, whereas in the US they tend to be registered in order to comply with US securities regulations and tax laws.

**Definitive bonds**

If bonds are issued in bearer form, these are paper certificates, one representing each individual bond in the issue (like banknotes). They are security printed documents (as explained below).

**Global bond**

A global bond is a word-processed certificate representing the total amount of bonds issued in a single issue. Because bonds tend to be traded electronically, individual investors now rarely receive definitive bonds in paper form. As a result, on issue, a single global bond in certificate form is created and held by a custodian bank called the **common depository**.

A global bond may start as a temporary global bond, which can be exchanged for a permanent global bond after a certain period. Both the temporary and permanent global bonds will commonly be word-processed documents printed by the lead manager’s solicitors. The use of global bonds saves the costs involved in security printing definitive bonds. Security printing is a method of printing which aims to prevent forgery, tampering or counterfeiting by using techniques such as printing on security paper. Common examples of security printed documents are banknotes and passports. There is a considerable expense involved with security printing.

The main use of temporary global bonds is as a way of controlling the distribution of the bonds on the primary market to comply with selling restrictions (explained later on).

**Transfers of bonds**

**Transferability** – ease of transfer is essential for the bond markets to function efficiently and to make bonds attractive to investors. Other than delivery, there are no formalities to be satisfied for the legal transfer of a bearer bond. In the case of a registered bond, the transferee’s name must be registered in the register of bondholders for legal ownership to be transferred.

**Negotiability** – negotiability is another essential factor to ensure bond markets function efficiently. This means a bona fide purchaser for value without notice of a prior encumbrance can take good title (i.e. possibly better than the seller’s).

**Listed/unlisted** – we will explore this further later in Workshop 9.

**Selling restrictions –** selling restrictions are a summary of the laws in particular jurisdictions regulating the offer and sale of debt securities in those jurisdictions. Their effect is to impose restrictions on the sale of bonds (i.e. the way the bonds are sold or to whom they can be sold) and they are enforced by securities regulators in most jurisdictions around the world. As such, they vary from country to country. The purpose of selling restrictions is to protect the issuer from inadvertently breaching local securities laws and to prevent tax evasion.

Their effect is that any bond sold in a particular jurisdiction must have been approved by local regulators, which generally means going through a listing procedure. Where the issue has not been subject to such scrutiny, then the bonds cannot be sold freely. Generally, when bonds have not been listed in a particular jurisdiction, sales to sophisticated investors (meaning financial institutions and professionals) are permitted while sales to the public at large are prohibited.

It is also important to note that selling restrictions are **contractual** restrictions imposed by the issuer to avoid any breach of regulations. Usually the bond documents (namely the subscription agreement, offering document and bond certificate) will contain a general selling restriction and country-specific selling restrictions for those jurisdictions where the bonds may be marketed.

**Electronic transfer –** most bonds are now transferred by electronic entry through the clearing systems.

**Price of bonds**

**Risk and return for investors**

When an issuer talks about pricing a bond, this generally refers to the interest rate it will offer to investors (although it may also refer to the amount the investor pays for the bond if that is not equal to the nominal amount). The price at which the issuer decides to issue a bond depends on a number of factors, but the primary factor is the amount of risk involved for the investor. The higher the risk, the higher the return an investor will expect to receive. If the interest rate does not adequately reflect the risk, the bond will not sell well.

**Factors to assess risk/fix price**

The starting point is the rate offered on a government security of the country of the currency of issue. This rate will then be increased depending on factors such as:

· The identity of the issuer: the better the financial health of the company, the lower the interest.

· The issuer’s sector of activity.

· The maturity date: the longer the loan, the higher the risk and the higher the interest.

· Extra features e.g. secured, guaranteed or equity-linked bonds: such features will allow the issuer to pay a lower interest rate.

· Prevailing market conditions and interest rates.

· Credit rating obtained from credit rating agencies (on the bond itself and the issuer).

**Credit Rating of a bond**

**Rating a bond:**

Issuers (including sovereign issuers) and each of their bond issues can be rated separately by institutions called credit rating agencies. The smaller the risk of default on the bond the better the rating. For example, for Standard & Poor’s the best possible rating is AAA, the worst is D. Anything below BBB- is considered to be of a speculative nature with respect to the borrower’s capacity to pay interest and repay principal. These bonds are referred to as sub-investment grade, high yield or junk bonds. Each credit rating agency has a similar scale.

A credit rating agency will analyse the risk both of the issuer and of that particular issue. For example, a secured issue will carry less risk than a non-secured issue, even if it is by the same issuer.

**Credit rating agencies**

Three of the main credit rating agencies in the UK are **Moody’s**, **Standard & Poor’s** and **Fitch**. Their ratings are similar and tend to move in line with one another.

To obtain a rating, issuers need to pay a fee and prepare a presentation about the bond issue and themselves to the agencies. The credit agency will then assign a rating to the issue.

The credit agencies’ role is then to monitor the market throughout the life of the bonds and change their rating (by way of upgrades or downgrades) according to developments relating to the issuer and/or the markets which may affect the issuer’s ability to repay the bonds. For example, during the sovereign debt crisis, Standard & Poor’s downgraded the rating of Eurozone countries such as Portugal, Cyprus and Greece to below investment grade. The idea is that investors can rely on ratings to decide whether to invest in a bond.

However, the credit rating agencies’ efficiency in doing this has been controversial and the agencies have been criticised. In particular, market participants considered that in a number of cases rating agencies merely followed the markets and changed their ratings when investors had already lost money and everybody knew where the risks lay. Rating agencies have also been criticised over the accuracy of their credit ratings and possible conflicts of interest.

**Clearing systems**

Ease of transfer is a fundamental characteristic of the international bond market. However, to trade definitive bonds quickly and in large numbers would be difficult and they would be vulnerable to loss or theft in the same way as cash. To facilitate speedy trading and improve security, the market uses institutions known as **clearing systems** to electronically record transactions (settle trades), collect interest and other payments on behalf of the bondholders and take custody of the global bonds.

These clearing systems are owned and financed by the major banks, which are also the main users of the systems, and in this capacity, are called **participants.** Only banks and other financial institutions are participants in the clearing systems. Individual investors are not direct participants and will hold their securities through a participant.

Most Eurobonds are held in the two main clearing systems: Euroclear (based in Brussels) and Clearstream (based in Luxembourg). For information only: in the US, the main clearing system is the DTC (Depositary Trust Company).

**Participants: cash/securities accounts**

Each participant has two accounts with the clearing system it is a participant in, one cash account and one securities account. These work in a similar way to a bank account. When a participant buys bonds, an electronic entry is made to increase the securities held in its securities account and the price of the bonds will be debited from its cash account. The seller of the bonds will have the opposite entries in its accounts. As a result, paper money and paper bonds are rarely used. Most bondholders will never see a bond.

Most banks and financial institutions have accounts both in Euroclear and Clearstream. Both Clearstream and Euroclear have an account with each other to facilitate transfers between the two systems. Bond issues are given a number (called an ISIN or CUSIP number), so that they can be identified in the electronic clearing systems.

**Depository/common depository**

A depository is a financial institution appointed by a clearing system to act as custodian of global bonds. Once issued, a global bond will be delivered to the depositary which will safeguard and hold the bond on behalf of the clearing system. The individual bonds will be traded electronically and will be represented physically only by the global bond. This is known as the ‘**classic global note** structure.’ A common depositary is a depositary appointed jointly by Euroclear and Clearstream.

**Summary**

· Different types of bonds have different interest rates, such as fixed rate bonds, floating rate bonds and variable rate bonds.

· There are also equity-linked bonds such as convertible bonds, exchangeable bonds and bonds with warrants.

· Other types of bonds include sovereign bonds, notes and plain vanilla bonds.

· The form of a bond will also vary such as ‘bearer/registered bonds,’ ‘definitive bonds’ or ‘global bonds.’

· There are a number of factors that will influence the transfer of a bond: transferability, negotiability and whether the bond is listed or unlisted.

· Credit ratings are attached to a bond.

**Parties to a bond issue and bond documentation**

This element discusses each of the parties involved in a bond issue and the key documents prepared for a typical bond issue.

**Parties to a bond**

· Issuer and Guarantor

· Lead Manager

· Joint-lead Managers and Co-Managers

· Principal paying agent and paying agents

· Fiscal Agent OR Trustee

· Legal advisers, auditors and other parties

**Issuer and guarantor**

The issuer issues securities and will sometimes be backed by a guarantor. For a corporate issuer the guarantor (if there is one) will often be a company in the same group. Any guarantor will be a party to the same agreements as the issuer.

**Lead Manager**

Generally, an investment bank acts as lead manager. This will either be the issuer’s relationship bank or a bank that pitched (i.e. approached the issuer with its proposal) for business and, as a result, has obtained a mandate from the issuer. The lead manager has a leading role in the bond issue and will gain large fees and prestige from its position as lead manager. Its main responsibilities will be to:

· **Assess market risk and advise on the structure, timing and target market -** taking into account the factors we looked at in relation to the pricing of a bond, it will advise the issuer as to the best (cheapest) way to raise the funds it needs (i.e. how can the issuer pay the least interest). For example, it may advise the borrower to borrow in one currency rather than another if it is cheaper to borrow in that currency.

· **Manage the entire issue procedure -** responsibilities will include ‘building the book’ which means forming the **underwriting syndicate,** negotiating the documentation and making sure all conditions precedent are complied with, carrying out the due diligence and organising the **roadshow** (i.e. presentations by the issuer to potential investors). It will also advise on issues such as whether to appoint a trustee or a fiscal agent, how to choose governing law and selecting lawyers. It will co-ordinate the different stages of the bond issue, including launch, signing, listing and closing, with the help of its legal advisers.

· **Form a syndicate -** the syndicate is the group of banks who buy the bonds from the issuer in the primary market and then resell them in the secondary market. They generally also underwrite the issue and receive an underwriting fee. As soon as the lead manager has obtained the mandate from the issuer, it will start **building a book.** This means contacting other banks to see whether they would be interested in buying/underwriting this issue and being part of the syndicate. If there is a lot of demand, the lead manager will advise the issuer to offer a low interest rate. If the market is slow, the lead manager may go back to the borrower and advise that the interest offered should be higher or that the terms of the bond should be varied to attract investors.

· **Liaise with the listing authority -** if the bonds are to be listed and admitted to trading on a stock exchange, and if required by the listing authority, a bank or law firm is appointed to liaise with the relevant listing authority (in the UK, this is the FCA). Usually, the lead manager’s lawyers will carry out this role. The bank or law firm (referred to in some jurisdictions as the ‘listing agent’) will advise the issuer on the procedure for listing and will submit the documents for listing on the relevant exchange.

In commercial terms, the lead manager will take responsibility for the success or failure of the issue. The harm a failed deal can have on a manager’s reputation is huge. Once an announcement has been made to the market that bonds are due to be issued, even if market conditions change and by going ahead the lead manager makes a loss, it will rarely cancel a deal.

**Joint-lead managers and co-managers**

In large issues there may be more than one lead manager and together they are referred as ‘joint-lead managers.’ The lead manager (and if relevant each joint-lead manager) will put together a group of banks to initially subscribe for the bonds on issue. This group of banks is referred to as the ‘co-managers’ and together with the lead manager/joint-lead managers, they are commonly referred to as the ‘managers.’ The co-managers will usually underwrite the bond issue with the lead manager. These positions are also prestigious.

**Principal paying agent and paying agents**

There is a principal paying agent responsible for co-ordinating the overall process of the payment of principal and interest to the bondholders throughout the life of the bond. There is also (for convenience and tax issues) a paying agent in each jurisdiction where payments to bondholders are made.

The principal paying agent is the agent of the issuer and is responsible for co-ordinating payments of principal and interest under the bond, maintaining records of payments and, for bonds held in definitive form, replacing lost or damaged bonds. If the issuer uses a fiscal agent, the same entity will often act as principal paying agent as well.

**Fiscal Agent OR Trustee**

Bond issues require an entity to administer the issue until maturity and to ensure that everything runs smoothly. This will be the role of either a trustee or a fiscal agent. These alternatives achieve very different results. Using a fiscal agent is the cheapest method. However, the choice between a fiscal agent and a trustee is ultimately determined by the circumstances and preference of the issuer.

**Fiscal agent**

The fiscal agent is a bank which is appointed by and represents the issuer. The fiscal agent’s powers are set out in the fiscal agency agreement. Its main responsibilities are to administer the payment of interest and principal to the bondholders and generally the fiscal agent will also act as the principal paying agent. It owes no duty of care to the bondholders. It also has some administrative functions, such as publishing notices to the bondholders (for example to call a meeting), acting as depositary for the issuer’s financial information and maintaining the records relating to the issue.

**Trustee**

Generally a professional trust corporation (either a subsidiary or division of a bank or a stand-alone entity) will act as trustee. The trustee’s powers are recorded in a trust deed. The Trustee represents the interests of the bondholders (unlike the fiscal agent) although is still appointed by the issuer.

Its main responsibilities are to ensure that everything runs smoothly throughout the life of the bonds. It has administrative powers similar to those of a fiscal agent such as acting as depositary for the issuer’s financial information and calling bondholder meetings but also has wider powers to act on behalf of the bondholders. For example, the trustee can call a default and can agree to minor non-prejudicial matters on behalf of the bondholders. However, the trustee will be reluctant to use its discretionary powers and, to avoid any liability, will generally act only on the bondholders’ instructions in the case of anything but a genuinely minor modification or waiver.

Where a trustee has been appointed, bondholders generally cannot sue the issuer directly, they can only do so through the trustee. In addition to the powers set out in the trust deed, the trustee owes a common law duty of care to the bondholders in the exercise of its powers.

**Fiscal Agent or Trustee – how to choose between the two…**

Ultimately, it is the issuer’s decision and factors an issuer may consider are as follows are as follows:

· **Security**

· **Convertible bonds or bonds with complex terms***-* in such situations it is more convenient for the issuer to have a trustee and more reassuring for the bondholders, as they have a party representing them that will monitor the conversion mechanics or other more complicated provisions such as financial covenants or if there is one or more events of default.

· \*\*Subordination*-* \*\*this means that any payments on the bonds can only be made after another set of payments owed in respect of another bond issue have been paid in full, or indeed (as with securitisation) where a bond issue is structured so that bonds are issued in tranches with some tranches ranking ahead of others in terms of repayment. A trustee may be useful to enforce the subordination terms and direct the payments pursuant to it (although a trustee will not be responsible for making such payments - this role will be performed by the principal paying agent). Unlike the security issue, a trustee is not absolutely necessary, as subordination can be included in the actual terms of issue.

· **Local law***-* local law may not recognise a trustee structure (e.g. certain civil law jurisdictions) in which case a fiscal agent will have to be used.

· \*\*Modifications and waivers*-* \*\*if a trustee is satisfied there would be no material prejudice to bondholders, a trustee can agree to modifications to the bond terms without having toconvene a full meeting of the bondholders, as would be the case where a fiscal agency structure is used.

· \*\*Trustee action on default of the issuer*-* \*\*before taking a particular course of action, the issuer can check with the trustee to get a view as to whether any proposed issuer action would trigger an event of default under the bonds. Only the trustee can act on default of the issuer (either unilaterally or if directed to do so by a specified majority of the bondholders, subject to the terms of the bonds and the trust deed). The bond terms and conditions may contain requirements for the trustee to certify to the issuer that an event of default, which in the trustee’s opinion is materially prejudicial to bondholders, has occurred. Such a certification requirement will usually not apply to non-payment or insolvency.

In a fiscal agency structure, all the bondholders have a right to accelerate the bonds, even on occurrence of a very minor technical breach. Therefore the issuer is dealing with one trustee rather than a multitude of bondholders. The trustee is likely to take a more considered approach to a default by the issuer in deciding whether or not to accelerate the bonds. In addition, the trust deed may allow the trustee to waive technical events of default in its discretion.

**Legal Advisers, auditors and other parties**

· **Lawyers -** generally, the lead manager will appoint lawyers, who will act in the interests of the managers as a whole and the issuer should appoint its own legal advisers. A third set of lawyers will be needed if there is a trustee as it will need to have separate counsel (although often the same firm - but not the same lawyer - will represent both the managers and the trustee). The lawyers will draft all the documentation and advise as to legal matters.

· **Auditors -** the auditors will be responsible for carrying out financial due diligence on the issuer’s accounts. This is particularly important as very often when the bonds are issued there will have been several months since the publication of the issuer’s latest audited accounts. The lead manager will instruct the auditors to carry out a set of procedures and to confirm that there has been no material change since the last set of audited accounts by way of a comfort letter. The auditors will also generally provide a consent letter to allow their report to be included in the prospectus. The company’s auditors will generally be appointed as the auditors for the bond issue since they will be familiar with the issuer’s accounts.

· **Other parties** – other parties involved include ‘depository’ or ‘common depository’ and ‘clearing systems’ which were covered in the previous element.

**Documents for a bond issue**

· Mandate letter

· Offering document

· Subscription agreement

· Confirmation to managers

· Agreement among managers

· Fiscal agency agreement

· Trust deed

· Principal paying agency agreement

· Deed of covenant

· Bond terms and conditions

· Auditors comfort letters

· Legal opinion

**Documents for a bond issue**

**Mandate letter:** This document sets out the terms of appointment of the lead manager whose role it is to advise the issuer and to manage the bond issue.

**Offering document/Prospectus:** This document will contain detailed information about the issuer, its business and the bonds themselves and is aimed at potential investors. It will also incorporate the terms and conditions of the bonds (discussed below). The type of offering document produced will depend on factors such as whether the bonds are to be listed.

**Subscription Agreement:** This is the contract between the issuer and the managers which sets out the basis upon which the issuer will sell, and the managers will buy the bonds. It covers matters such as the pricing of the issue (i.e., the interest rate payable on the bonds) and representations and warranties given by the issuer to each of the managers. It also sets out an indemnity provision for the benefit of the managers in respect of any breach of undertaking by the issuer or misrepresentation (in the period between signing and closing).

**Agreement Amongst Managers:** This records how the managers agree how to ‘share out’ their joint and several liability. The ICMA's version of this agreement is used in most bond issues.

**Confirmation to managers:** This document forms the basis of the managers’ commitments in the bond issue and is sent out by the lead manager to the co-managers confirming their participation in the bond issue. It also sets out the main terms of the proposed bond issue.

**Fiscal Agency Agreement:** This document sets out the detailed mechanics for payments of principal and interest under the bonds, as well as administrative matters such as calling bondholder meetings.

**Trust Deed:** Its main function is the creation of a trust whereby the trustee holds the benefit of the issuer's covenant to pay upon trust for the bondholders and permits payments through the principal paying agent. The trust deed also provides for trustee's powers and duties, such as the extent of its powers to call an event of default. See points above regarding role, powers and advantages of a trustee.

**Principal Paying Agency Agreement:** Similar to a fiscal agency agreement**,** the main function is to document the mechanism by which payments are made to the bondholders on behalf of the issuer, given that the issuer is not able to make payments to bondholders directly.If there is a trustee structure, a fiscal agent will not be appointed. So, an issuer will need to appoint a separate principal paying agent to administer payments of coupon and principal.

**Deed of covenant:** This document is signed by the issuer (and the guarantor if applicable) and enables the bondholder to enforce the bonds directly against the issuer if the issuer defaults (e.g., on payment or doesn’t deliver definitive notes). Needed in a fiscal agency structure, but not in a trustee structure.

**Terms and Conditions:** These are found in the offering document (among other places, such as in a schedule to the fiscal agency agreement or trust deed) and deal with matters such as type of interest (e.g., fixed or floating rate), how it is calculated and how it is paid, undertakings given to bondholders (e.g., negative pledge), events of default and enforcement powers of a trustee (if a trustee structure is used).

The terms in a bond are usually fewer and less onerous than in a facility agreement. For example, the negative pledge in a bond will be less onerous than the negative pledge required by lenders in a loan agreement. See the example below. A bond negative pledge ensures an issuer will not issue bonds ranking higher than the current issue unless the bondholders of the current issue receive the same rights. A more restrictive form (as found in loan agreements) would be unworkable in the bond markets as it would require a bondholder's meeting to obtain a waiver if it is breached.

**Example of bond negative pledge**

**Negative Pledge**

So long as any Note remains outstanding (as defined in the Trust Deed):

the Issuer shall not and shall procure that no Material Subsidiary shall create or have outstanding any mortgage, charge, lien, pledge or other security interest (each a Security Interest) upon, or with respect to, any of its present or future business, undertaking, assets or revenues (including any uncalled capital) to secure any Relevant Indebtedness (as defined below), unless the Issuer promptly takes any and all action necessary to ensure that:

(i) all amounts payable in respect of the Notes and the Coupons and under the Trust Deed in respect thereof are secured by the Security Interest equally and rateably with the Relevant Indebtedness; or

(ii) such other Security Interest or other arrangement (whether or not it includes the giving of a Security Interest) is provided as is approved by the Trustee in its absolute discretion deeming it not materially less beneficial to the Noteholders or by an Extraordinary Resolution of the Noteholders.

**Bond issue events of default**

Due to greater difficulty to obtain waivers from bondholders (compared to lenders in a facility agreement), the events of default in a bond are less numerous and more flexible than in a facility agreement.

**For example:**

· Non-payment of principal and non-payment of interest usually have different grace periods, both of which are more generous than the grace period found in the non-payment event of default in a facility agreement.

· Cross-default clauses usually have a high de minimis threshold.

**Legal opinions:** legal opinions will be required by the lead manager from (a) their own lawyers in respect of the binding nature of the bond documentation; and (b) the issuer’s lawyers confirming (among other things) due incorporation of the issuer and enforceability of the contractual documents against the issuer. Opinions from foreign lawyers will be required if the bond issue involves overseas jurisdictions.

**Auditor’s comfort letter:** This document is produced at signing and closing and confirms that any audited financial information contained in the offering document is correct and not misleading and that any unaudited financial information in the offering document has been prepared in accordance with generally accepted accounting principles. It also confirms that there has been no material adverse change in the issuer’s financial position since the latest audited accounts.

**Summary**

· There are various parties involved in a bond issue:

Ø Issuer and guarantor.

Ø Lead manager.

Ø Joint-lead managers and co-managers.

Ø Fiscal agent or trustee

Ø Principal paying agent and paying agents.

Ø Legal advisers, auditors and other parties.

· When determining whether to use a fiscal agent or a trustee certain factor will be considered such as security, subordination, local law and cost.

· There are various documents required in a typical bond issue:

Ø Mandate letter.

Ø Offering document.

Ø Subscription agreement.

Ø Agreement among managers.

Ø Confirmation to managers

Ø Fiscal agency agreement or trust deed.

Ø Principal paying agency agreement (if a trust deed is used).

Ø Deed of covenant (if a fiscal agency agreement is used).

Ø Bond terms and conditions (incorporated into other documents such as the offering document and fiscal agency agreement or trust deed).

Ø Auditor's comfort letters and legal opinions.

**Procedure for issuing a bond**

This element discusses the procedure for issuing a bond – comparing listed and unlisted bond issues.

**Introduction**

In conjunction with the issuer, the lead manager’s lawyers will prepare an offering document to assist in marketing the bonds. This will describe the issuer, explain the offer terms, contain historical financial statements in respect of the issuer and certain other information that would help an investor decide if the investment is suitable. This may be referred to as an offering or placement memorandum or an offering circular. In the past, market expectation was that the content of the offering circular of an unlisted issue would still generally follow the requirements of the (then in force) listing rules.

In certain circumstances (including where the bond issue is to be listed), there are specific requirements for the type of offering document (e.g. Listing Particulars or a Prospectus) and its contents.

**Offering document – which type?**

Sections 85(1) FSMA requires that an approved **prospectus** must be prepared in relation to any **offer to the public** of transferable securities in the UK and s.85(2) FSMA requires that an approved **prospectus** must be prepared in relation to **admission to trading on a regulated market** (see below for discussion of a regulated market) of transferable securities in the UK – i.e. if either of those two requirements are met, the offering document must take the form of a prospectus.

Even where a bond is unlisted and does not constitute an offer to the public because it falls within an exemption, an offering document will usually be prepared for marketing purposes. This document will be known an offering circular.

Where bonds are listed on an unregulated market (such as the Professional Securities Market (‘**PSM**’) discussed below) an offering document known as ‘listing particulars’ will be prepared.

Another unregulated market to which bonds may be admitted to trading is the International Securities Market (‘**ISM**’), which will require the preparation of an offering document known as ‘admission particulars. See further below.

The key difference between the different types of offering documents is the degree of disclosure that is required. A prospectus requires a higher degree of disclosure than listing Particulars or admission particulars.

**Exempt offers to the public**

Even if the bond is offered to the public, section 86(1) FSMA sets out exemptions from the requirement to provide a **prospectus** under s. 85(1), provided the bond is not admitted to trading on a regulated market (i.e. the bonds are admitted to trading on the PSM or the ISM). These exemptions are set out Article 1(4) of the UK Prospectus Regulation and are referred to in the Prospectus Regulation Rules (**‘PRR’**) namely PRR 1.2.3. These exemptions include offers addressed to either qualified investors only or to fewer than 150 non-qualified investors per EEA state (amended to refer only to the UK following Brexit).

‘**Qualified investors**’ is defined in the UK Prospectus Regulation and includes governments, central banks and other entities authorised to operate in the financial markets.

Sections 85(5) and (6) FSMA provide additional exceptions for the requirement for a prospectus. These exceptions (none of which is likely to apply to bonds) are found in PRR 1.2.2.

**Admission to trading on a regulated market**

The Main Market of the London Stock Exchange ('**LSE**') is a regulated market for the purposes of s 85(2) FSMA. A bond that is to be listed (i.e., admitted to trading) on the Main Market will therefore require a prospectus (even if the offer is addressed to qualified investors only).

As well as the LSE’s Main Market for bond trading, there are two alternative trading platforms which, as mentioned above, do not constitute a regulated market, namely the PSM and the ISM. These are available for the trading of specialist securities.

Specialist securities are defined as securities normally bought and traded by a limited number of investors who are particularly knowledgeable in investment matters. Such securities include bonds.

If bonds are admitted to trading on the PSM or the ISM and the offer does not constitute an 'offer to the public' (i.e. it falls within an exemption such as an offer to qualified investors only as discussed above), a prospectus will **not** be required. Instead, ‘listing particulars’ will be prepared for the PSM in accordance with FCA rules and ‘admission particulars' will be required for the ISM in accordance with the LSE's own rules for admission to trading on the ISM.

**Listing a bond:** Although the term ‘listing’ is generally used, there are technically two separate stages involved:

· ‘admission to listing’ of the bonds on the ‘Official List’ held by the Financial Conduct Authority (‘**FCA**’); and

· ‘admission to trading’ of the bonds on the London Stock Exchange (‘**LSE**’).

As we will see, in certain circumstances, part of this process requires the approval and publication of a prospectus. Under the Financial Services & Markets Act 2000 (**‘FSMA**’), the FCA is both the listing authority and the competent authority for approving prospectuses in the UK.

**Bond issue procedure**

The following summary of the procedure for issuing a bond relates to a bond where a prospectus is required and there is one lead manager.

**Mandate**

Under the terms of a **mandate letter**, the issuer will appoint a bank to act as lead manager who will advise the issuer on matters such as the structure of the bond issue (fiscal agent or trustee structure) and which investors to target with a view to outing together a syndicate of bank (the co-managers) who will initially subscribe for the bonds. Prior to **launch** of the bond issue (see below), the lead manager’s solicitors will prepare all the bond documents and submit a first draft of the prospectus to the FCA for comments.

The finalised prospectus (i.e. clear of any comments) should be ready prior to any roadshows or the launch date. The lead manager will assist the issuer with any roadshows which are aimed to familiarise potential investors with the issuer’s business and attract potential investors to subscribe for the bonds on **signing** (see below). The actual transfer of bonds and funds will take place on **closing** (see below).

**Due Diligence**

The lead manager or their lawyers will conduct due diligence in respect of the issuer and based on this information, prepare the offering document.

This is a fact-finding exercise to verify the information provided by the issuer and to ascertain what further information is needed. For a listed bond, the due diligence process will be driven by the need to comply with disclosure requirements for listed bond prospectuses.

The aim is to protect the lead manager from potential liability under FSMA and the Prospectus Regulation Rules.

**Launch**

The launch of a bond issue is effectively a formal announcement of the planned issue of the bonds. It is usually timed to follow completion of any due diligence and roadshows and when market conditions are favourable.

The lead manager will send out an **initial syndicate**

The co-managers have 24 hours to respond to the invitation in the initial syndicate communication inviting them to subscribe for the bonds.

Pricing of the bonds (i.e. determining the price of the bonds to be sold on the primary market) may occur on the same day as launch or after launch but prior to signing.

Once the issue size and pricing of the bonds is known, the lead manager will send out a confirmation of allotment (a **Confirmation to Managers**) to the co-managers which sets out the basis of the manager’s commitment (subject to the signing of a subscription agreement).

The Confirmation to Managers, together with any annexed term sheet and the initial syndicate communication should contain the material terms of the issue and such other information as will allow the managers to confirm their participation in the issue/transaction.

Such information will include, as a minimum, names of the managers in the syndicate, respective underwriting commitments and allotment information, the commercial terms of the issue/transaction, and documentation considerations (e.g. whether the bonds are being issued on a standalone basis or as part of a programme).

**Signing**

The following takes place on signing:

· the prospectus is approved by the FCA and listing applications are submitted;

· delivery of the first comfort letter by the issuer’s auditors (confirming no material change in the financial condition of the issuer since the last set of audited accounts); and

· execution of the subscription agreement and the agreement among managers. The lead manager and other managers are legally bound at this point to subscribe for the bonds allocated to them (see further below).

It is standard practice for signing to take place virtually i.e. using e-mail and scanned copies of the relevant documents. Note that electronic signing using electronic signatures on an e-signing platform (e.g. DocuSign) is becoming more common.

The subscription agreement deals with the arrangements for the issue and subscription of the bonds with the managers agreeing to subscribe for the bonds on a joint and several basis so that the issuer has certainty that all the bonds will be bought.

The agreement among managers covers the arrangements between the managers and governs their liability and obligations in relation to each other. It also confirms that the managers subscribe for the bonds on a joint and several basis and specifies the proportion of the bond issue each manager will subscribe for.

It is an International Capital Market Association (the ‘**ICMA**’) requirement that all managers receive the final draft of the subscription agreement and of the agreement among managers at least two working days before the signing date. The obligation to subscribe for the bonds does not take effect until closing (see below), and only then after a number of pre-determined conditions precedent are satisfied. Therefore, there is no transfer of funds or bonds at signing.

**Closing**

Approximately one week after signing, closing is the transfer of the bonds to the managers and the funds to the issuer. This is all done through the clearing systems.

The intervening days between signing and closing are used by the parties to finalise the outstanding documents and to co-ordinate the payment procedure between the lead and co-managers, the clearing systems, the common depository) and the issuer.

At closing the parties will check that all conditions precedent have been satisfied.

Admission to trading happens the day after closing for London listed standalone bond issues.

The following documents should be executed or provided:

· Trust deed OR fiscal agency agreement;

· Principal paying agency agreement (if required);

· Deed of covenant (if required);

· Auditor’s second comfort letter. This is a short letter confirming that the contents of the first comfort letter delivered to the managers on signing remain correct;

· Legal opinions: one from the lead manager's solicitors confirming the binding nature of the bond documentation and one from the issuer's solicitors confirming among other things the due incorporation of the issuer;

· Issuer’s closing certificate. This is a certificate signed by the issuer stating that: (1) the representations made by the issuer in the subscription agreement remain true and accurate as at the date of closing; (2) there has been no material adverse change in the issuer’s financial condition since the execution of the subscription agreement; and (3) the issuer has performed all its obligations under the subscription agreement on or before the closing date;

· Global bond (generally in temporary form), which will be signed by the issuer and authenticated (signed) by the fiscal agent or principal paying agent;

· Cross-receipt letters from the issuer and the lead manager are signed and exchanged recording that the bond issue has closed. They state, respectively, that the managers have received the bonds and that the issuer has received the funds; and

· Payment instructions from the lead manager to the common depository.

If the issue is to be listed, the issuer will need confirmation from the FCA that it has approved the offering document.

Some documents may be signed earlier than the closing date and held in escrow (effectively held on trust) by the lead manager’s solicitors. There will be a number of other ancillary documents to provide such as incorporation certificates, board minutes or regulatory approval, depending on the type of issuer and the type of bond involved.

In terms of the mechanics of payment, the system which is most commonly used to ensure that cash and bonds change hands simultaneously is known as ‘**payment against delivery.’** Under what is known as the ‘**classic global note structure’** payment for the bonds is co-ordinated by the lead manager (on behalf of the syndicate) through the clearing systems.

Prior to closing, the co-managers will instruct the clearing systems to transfer, on closing and subject to receipt of the bonds, cash from their respective cash accounts to the lead manager’s account.

On closing, the lead manager will instruct the clearing systems to transfer the total amount due to the issuer to the common depository. The common depository acts as a go-between. **Timing considerations**

The time it takes to complete a bond issue will vary from a few days to several months depending on a number of factors such as:

**Seasoned issuer (i.e. regular player on capital markets) or first-time issuer:** A seasoned issuer will be able to update an existing disclosure document rather than start from the beginning thereby shortening the process at the due diligence stage.

Also, frequent issuers will usually set up and issue bonds on a regular basis under an euro medium term note (‘**EMTN**’) programme. This enables frequent issuers to raise money at short notice on the basis of master documentation which is updated on an annual basis or supplemented if necessary, on an issue-by-issue basis. Conversely, a new issuer will have to spend more time on due diligence to put the offering document together. More effort may need to go into investor roadshows for new issuers to generate more interest in the bonds in the market before the issue is launched.

**Type of bond (i.e. plain vanilla or with special features):** If the bonds are to be issued with special features such as convertible or exchangeable bonds, more complex provisions will need to be built into the documentation which will impact on the timetable due to the additional disclosure, drafting and negotiation involved.

**Credit rating of issuer:** A rating will be assigned to the bond issue on launch by a specialist independent rating organisation (the best known of which are Moody’s Investors Service, Standard and Poor’s and Fitch Ratings). A credit rating is an opinion on the risk of the issuer defaulting on its payment obligations. There are two broad categories of rating which include ‘investment grade’ (i.e. low risk of non-payment) and ‘speculative grade’ (i.e. higher risk of non-payment). If the credit rating is below investment grade, more time and effort will need to go into investor roadshows to generate investor interest in the pre-launch stage.

**To list or not to list?**

**Advantages of listing:**

Because bonds are generally bought by, and sold to sophisticated investors, listing is sought for other reasons than accessing the public marketplace. Most trading will happen on the over the counter (‘**OTC**’) market rather than on stock exchanges.

The OTC market is simply trading via the telephone or computer screens between investment professionals. In this context, a key advantage of listing is that it makes a bond more marketable (and, as the bond is easier to sell, the interest paid by the issuer can be lower) for a number of reasons:

· because investors know that the listing requirements have been complied with, it makes them more confident in the quality of the information they are being given;

· it gives the issuer access to institutional investors (they are the biggest buyers of bonds), which are generally required to hold their investments in listed securities so that they can be readily sold; and

· Investors can benefit from the quoted eurobond exemption. This means issuers can pay interest free of withholding tax. As well as securities admitted to trading on the Main Market, securities admitted to the PSM and ISM will also fall within this exemption.

**Disadvantages of listing:**

The three main disadvantages for the issuer are:

· **cost**: the FCA and the LSE each charge a fee and legal fees will be considerably higher because of the additional time involved in listing a bond (especially for a first-time issuer);

· **timing**: the listing process is more time-consuming. This is particularly the case for a new issuer where due diligence and drafting of the prospectus will have to be undertaken from scratch. The specific requirements for listing will vary depending on the exchange on which the issuer is listing the bonds;

· **disclosure**: the listing process requires public disclosure of a great deal of information regarding the issuer and its business which, for business reasons, the issuer may wish to keep confidential; and

· **continuing obligations:** an issuer of London-listed bonds will need to comply with continuing obligations imposed by the FCA and the London Stock Exchange as found in, for example, the Disclosure Guidance and Transparency Rules and the UK Market Abuse regime. These are not considered in detail on this knowledge stream.

**Where are bonds listed?**

· London is, at present, one of the principal markets in Europe on which to list debt securities. Other principal European markets include Luxembourg (the Luxembourg regulated market or the Euro MTF) and Ireland (Main Securities Market or the Global Exchange Market (‘**GEM**’)). This knowledge focuses on a London listing (though note that as practitioners you will also become familiar with overseas listing processes).

· As mentioned, obtaining a listing for bonds in London involves two processes (a) admission to the 'Official List' held by the FCA; and (b) admission to trading on the London Stock Exchange’s **Main Market** which is a ‘regulated market’; or on either the PSM or ISMA which are ‘unregulated markets’.

· The PSM and the ISM, as discussed previously, are unregulated markets. Whilst the disclosure rules for the PSM are created by the FCA, the disclosure rules for the ISM are created by the London Stock Exchange rather than the FCA. Both the PSM and the ISM offer issuers a less onerous disclosure regime and greater flexibility than the Main Market.

**Regulatory framework**

Historically, because investors in eurobonds were viewed as relatively sophisticated it was concluded that they required less information or protection when considering their investments compared to members of the public. As a result, the FSA (the predecessor to the FCA) adopted a lighter touch to the listing and trading of bonds.

The three key regulations which govern prospectuses are:

· the UK Prospectus Regulation (which is derived from Regulation (EU) No 2017/1129) (the '**UK Prospectus Regulation**’);​

· the UK Prospectus Delegated Regulation (which is derived from Commission Delegated Regulation (EU) 2019/980) which governs the format, content, scrutiny and approval of prospectuses (the '**UK** PR Regulation'); and​

· the UK Prospectus RTS Regulation (which is derived from Commission Delegated Regulation (EU) 2019/979) which addresses a range of ancillary issues including advertisements and supplementary prospectuses (the '**UK Prospectus RTS Regulation**’).​

Each of these regulations forms part of the retained EU law which was adopted directly into English law under the European Union (Withdrawal) Act 2018, following the end of the Brexit implementation period.

Other important law and regulation in the context of prospectuses is found in the following sources (those highlighted are explained further in the following pages):​

· Financial Services and Markets Act 2000 ('**FSMA**');​

· the Prospectus Regulation Rules ('**PRRs**');​

· the Listing Rules ('**LRs**'); ​

· the Disclosure Guidance and Transparency Rules sourcebook ('**DTRs**');​

· materials relating to the European prospectus regime published by the European Securities and Markets Authority ('**ESMA**');​

· the UK Market Abuse Regulation (derived from Regulation 2014/596/EU) ('**MAR**’);

· the Financial Services Act 2012 (**'FS Act**'); and

· Financial Services and Markets Act 2023

The provisions of the UK Prospectus Regulation and the UK PR Regulation are reflected in the Prospectus Regulation Rules (see below) and amendments to Part VI FSMA.

FSMA is the authority for the FCA's enforcement powers in relation to the Prospectus Regulation and associated rules.

As a result, the FCA revised the relevant parts of its Handbook and published the following under the ‘Listing, Prospectus and Disclosure’ section of the FCA Handbook (https://www.handbook.fca.org.uk):

· the Listing Rules (‘**LR**’), which set out the requirements for listing;

· the Prospectus Regulation Rules (‘**PRR**’), which set out the requirements as to the format and content of the ‘prospectuses needed for the issue and listing of securities in the UK. The relevant provisions of the three key regulations mentioned previously are 'copied out' for ease of reference in the PRRs, alongside additional rules and guidance which are issued directly by the FCA. The reproduced regulation provisions are identified in the PRRs with the label 'UK'; rules have the label 'R' and guidance has the label 'G'; and

· the Disclosure Guidance and Transparency Rules (‘**DTR**’), which regulate areas such as the disclosure of ‘inside information’ and the rules on disclosure of information on an ongoing basis.

Whilst the FCA Handbook in places merely reproduces provisions of the various retained EU law instruments mentioned above, for the purposes of convenience, we will only use the FCA Handbook references, as though they are the primary legislation.

You are expected to be familiar with the FCA Handbook to the extent covered in Workshop 9. However, for the purposes of the assessment **you will only be expected to quote the relevant references to FSMA, the PRR and the relevant annexes. Any references to the LR are for information only.**

**Regulatory framework**

The European Securities and Markets Authority (‘**ESMA’**) aims to promote the integrity, transparency, efficiency and orderly function of European securities markets and to protect investors. For example, ESMA publishes Guidelines on Disclosure Requirements under the EU Prospectus Regulation which are intended to ensure that market participants have a common understanding of the disclosure which is required to be made in a prospectus.​

ESMA no longer has direct jurisdiction in the UK and its functions under the EU Prospectus Regulation regime have been transferred to the FCA with respect to the retained UK version of the regulation. However, the FCA has stated that it expects market participants to continue to apply the ESMA guidelines to the extent to which they remain relevant.

The Financial Services and Markets Act 2023 enables areas of financial services regulation in currently retained EU law to be moved into what is known as the 'comprehensive FSMA model'. This means that gradually retained EU law will be revoked and the FCA will be empowered to make rules for those areas to replace it. Current legislation is not expected to be revoked until relevant rules to replace it have been drafted, consulted upon and finalised. As at the date of these materials, this process is on-going. Therefore, there are likely to be some changes made to the regulatory regime relating to listed bond issues in the not too distant future.

**Bond listing requirements and procedure**

**Basic requirements**

The LR set out the requirements for listing bonds, which include:

· **admission to trading** on a regulated market for listed securities operated by a ‘regulated investment exchange’ (which includes the Main market of the London Stock Exchange); and

· publication of an **approved prospectus**.

As already mentioned, this means that three separate processes need to be successfully completed: (1) approval of the prospectus; (2) application for listing; and (3) application for admission to trading. These processes run in parallel with the underlying procedure for issuing the bonds.

Each of these processes will be considered in turn.

**Approval process for prospectus**

The documents listed in **PRR 3.1.1** (and specifically under Article 42) must be submitted to the FCA at least ten working days before the intended approval date of the prospectus (20 working days if the issuer does not already have securities admitted to trading) - **PRR 3.1.6**. All drafts of the prospectus must be submitted in searchable electronic format via electronic means.

In terms of timing, there is a legal and a practical requirement: under s. 85(2) FSMA, it is unlawful to request the admission of securities to trading unless an approved prospectus has first been made available to the public. Since, as we will see shortly, the application for the admission of the bonds to trading will be made soon after signing (see previous paragraphs relating to signing), the prospectus needs to be approved on the signing date.

At a practical level, the prospectus will need to have been finalised (save for pricing) ahead of launch. It will then be approved on the signing date.

The latest date for submission of the prospectus for approval is therefore ten (or twenty if it is a first-time issuer) working days before signing. However, the FCA may want to review and comment on more than one draft of the prospectus before it approves the final version and so it may (and often will) take longer than ten days. It takes approximately three days to review each draft of the prospectus.

**Obtaining a listing**

The issuer must comply with the procedure set out in the listing rules This includes requirements to provide a completed application for admission to the Official List and an approved prospectus at least two business days before listing is to be effective (i.e. before closing) and various other documents (including a written confirmation of the number of securities to be issued pursuant to a board resolution authorising the issue) on the day of listing.

Any documents that have been amended in response to comments from the FCA must be resubmitted once amended.

In timing terms, the listing must usually be effective at closing and so the application for listing will be submitted a few days before closing. Depending on the proposed timing for issue of the bonds, this may mean immediately after signing.

**Admission to trading**

The issuer must comply with the procedure set out in the listing rules**.** In practice, the application for admission to trading is submitted to the LSE at the same time as the application for listing is submitted to the FCA.

**What happens after listing?**

· The FCA Handbook rules **apply beyond listing**.

· Issuers of listed securities have **continuing obligations** during the life of the listing, including for example on-going disclosure obligations under the DTR.

· Such obligations include the **filing of periodic financial information** such as annual and interim reports (although the obligations vary depending on the nature of the securities and/or the nature of the issuer).

· The purpose of the DTR is to promote prompt and fair disclosure of relevant information to the market and to set out specific circumstances where an issuer can delay the public disclosure of inside information.

**Summary**

· An offering document will be prepared for marketing purposes. The type of offering document will depend on whether the bonds are to be listed, unlisted, constitute an offer the public and statutory requirements.

· If bonds are to be listed, the type of offering document will also depend on whether the bonds are listed on a 'regulated' market or an 'unregulated' market.

· There are various stages relating to the procedure of listing a bond – such as mandate, due diligence, launch, signing and closing.

· Timing considerations are also a crucial element.

· There is a regimented regulatory framework to adhere to alongside extensive bond listing requirements.

**Listed bond prospectus disclosure and potential liabilities**

This element discusses the disclosure requirements for listed bond prospectuses and potential liabilities that may arise in the context of a bond prospectus.

**Introduction**

Where a **prospectus** is required for a bond issue the requirements as to format and content are found in the Prospectus Regulation Rules ('PRR') which replicate the requirements of the UK Prospectus Regulation. The PRR are found in the FCA Handbook.

The PRR make a distinction based on the type of securities, the type of issuer and the denomination of the securities.

For bonds, different disclosure '**Annexes**' apply depending on whether the bonds are '**wholesale**' or '**retail**' (as further discussed below).

The 'Annexes' contain the minimum information to be disclosed and are replicated in 'checklists' which can be accessed on the FCA website.

**Wholesale or Retail**

The amount of information that needs to be included in a prospectus depends on the minimum denomination of the securities being issued:

· A **retail** issue is where the securities are issued with a minimum denomination of under €100,000 (or its equivalent in another currency). For a retail issue, Annexes 6 and 14 need to be complied with. Retail issues require more information to be disclosed.

· A **wholesale** issue involves minimum denominations of €100,000 or more (or its equivalent in another currency). For a wholesale issue, Annexes 7 and 15 need to be complied with.

· Also, if there is a guarantor providing a guarantee in respect of the bond issue, Annex 21 needs to be complied with.

Bond issues are either retail **OR** wholesale. You need to be able to identify what type of bond issue it is by looking at the lowest denomination that the bonds are being issued in. If the bond issue is wholesale:

· less information needs to be disclosed in the prospectus;

· a summary will **not** need to be prepared (**PRR 2.1.3**); and

· the criteria which the FCA must consider when undertaking the scrutiny of the comprehensibility of the information contained in a prospectus are reduced.

**General statutory disclosure requirements**

The general content of the prospectus is governed by FSMA and the ‘**informed assessment**’ test.

Section 87A FSMAsets out the general duty of disclosure which is the framework of what information is required to be included in the prospectus. However, the issuer must also consider the more detailed requirements of the LR and PRR as to disclosure and content of a prospectus.

Section 87A (as amended) makes reference to the information contained in Article 6(1) of the UK Prospectus Regulation. This information is set out in PRR 2.1.1 and means that the FCA may not approve a prospectus unless it is satisfied that the prospectus contains the necessary information which is material to an investor making an informed assessment of: (a) the assets and liabilities, profits and losses, financial position and prospects of the issuer and any guarantor; (b) the rights attaching to the securities; and (c) the reasons for the issuance and its impact on the issuer.

**Prospectus requirements**

**Document types**

**PRR 2.2.1** refers to three components of a prospectus. These are: a **summary** (in respect of a retail issue), a **registration document** (containing information relating to the issuer) and a **securities note** (providing details of the securities to be offered). Each of these components can be combined into a single prospectus or kept separate.

**Information required**

**PRR 2.3.1** sets out the minimum information requirements for a prospectus. This information is contained in the annexes set out in the UK Prospectus Regulation. The annexes apply according to the nature of the issuer and the type of securities being issued and separate annexes are required for both the registration document and the securities note. In addition, other annexes may also apply if the securities have special features (e.g. if the issue is guaranteed).

The UK Prospectus Regulation introduces the requirement to set out the risks that are material for the purposes of an investor taking an informed investment decision. The risk factors need to be categorised and presented in order of materiality within each category (**PRR 2.3.3**). The UK Prospectus Regulation has introduced a more prescriptive regime in relation to summaries, with the aim of making the summary section clearer and more concise (**PRR 2.1.4** to **2.1.6**). The summary must be a maximum length of seven sides of A4-sized paper and be split into four key sections, namely:

· an introduction – containing warnings;

· key information on the issuer;

· key information on the securities; and

· key information on the offer of securities to the public and/or admission to trading on a regulated market.

**Exemption from disclosure**

FSMA allows the FCA to authorise information to be omitted from a prospectus in the circumstances set out in **PRR 2.8.1**. These include that:

(a) disclosure would be contrary to the public interest, (b) that disclosure would be seriously detrimental to the issuer or the guarantor (and omission would be unlikely to mislead the public), or (c) that the information is only of minor importance and would not influence the assessment of the financial position and prospects of the issuer or guarantor.

**PRR 2.8.2** and **PRR 3.1.1 (Article 42(2)(d))** set out the procedure for requesting an omission of information. Such an application should be made to the FCA with the submission of the first draft of the prospectus, pursuant to **PRR 3.1.1**. However, in practice an issuer is likely to approach the FCA at an even earlier stage if omission is required.

It is important to note that information may only be omitted after an application has been submitted to and approved by the FCA. Also note that an issuer must identify in the relevant cross-reference list (corresponding to each annex) any information from the annexes that has not been included. A cross-reference list replicates the relevant annex and can be printed from the FCA website. See paragraph below on ‘verification’ for further detail.

**Drafting the Prospectus**

**Who drafts it?**

The lead manager’s solicitors will be primarily responsible for drafting the prospectus. The lead manager and the issuer will work together with their lawyers to ensure that the information is accurate and complete. The auditors of the issuer will be responsible for the financial information.

**Timing**

The first stage will be gathering information through the due diligence process, which happens between mandate and launch. If the issuer is new to the market, the prospectus will have to be drafted from scratch. If the issuer has already issued securities and previously prepared an offering document, then solicitors and auditors will only need to update the information.

Drafting can take several months for a first-time issuer, but, for an experienced issuer, the prospectus should generally be in close to final form within a month of the mandate. In practice, many bonds are issued under a euro medium-term note programme (known as an ‘EMTN Programme’). Under such a programme, a master offering document known as the ‘base prospectus’ is issued at the outset of the programme. A further document known as ‘final terms’ is then published in relation to each separate issue of bonds under the programme. This greatly speeds up the process of making subsequent issues of bonds under the programme.

**Verification, cross-reference lists and final approval**

The process of verification, which is common in relation to prospectuses for equity issues, is unusual for debt issues and is typically only required for issuers from emerging markets jurisdictions or with low credit ratings. Most prospectuses for debt issues are by companies or banks that are frequent issuers and well-known to investors. As such verification is not required.

Verification, where it takes place, is conducted by the issuer’s solicitors. They must verify all the information in the prospectus and ensure it is backed up by evidence. This is an important part of the process as it minimises potential liability arising from the issue by ensuring everything in the prospectus is checked for accuracy.

Before the prospectus can be used (or an application for admission to trading made – see s. 85(2) FSMA), it must be approved by the FCA. **PRR 3.1.1 and PRR 3.1.6** list the various documents which must be submitted to the FCA. The lead manager’s solicitors must send to the FCA the following;

· the **prospectus**- formerly it was a requirement that an annotated version of the prospectus be submitted to the FCA, showing where all the information required by the applicable PR Regulation annexes has been included in the prospectus. However, annotation is no longer a requirement under the PRR. Instead, there is a requirement to submit relevant cross-reference lists (see below). There is a requirement that the final draft of a prospectus should not be annotated (**PRR 3.1.1** (**Article 44** of the PR Regulation)).

· If the order of disclosure items in the prospectus does not coincide with the order set out in the relevant UK PR Regulation annex (which is typically the case with bond prospectuses), the issuer must also provide the FCA with the relevant cross-reference lists (**PRR 3.1.3**). These cross-reference lists correspond with the relevant UK PR Regulation annex and can be accessed from the FCA website. On the cross-reference list the issuer will indicate the specific page number in the prospectus where a particular required item of information has been disclosed.

· Separate cross-reference lists need to be completed showing information about the issuer and information about the securities. Which cross-reference list is used will depend on whether the securities are retail or wholesale.

· In addition, if the securities have the benefit of a guarantee, this will trigger the requirement to provide an additional cross-reference list containing information from the annex relevant to guarantees.

The lead manager’s solicitors will also (if necessary or if required by the FCA) identify, within the cross-reference list, any items from the relevant UK PR Regulation annexes that have not been included in the draft prospectus because they are not applicable due to the nature or type of issuer, securities, offer or admission to trading (as set out in Article 24(5) of the PR Regulation as referenced in PRR 3.1.1 and PRR 3.1.3).

In addition to complying with the PRR, the issuer must always make sure that, taking the prospectus as a whole, the informed assessment test in s. 87A/PRR 2.1.1 is complied with.

Finally, if applicable, the issuer’s solicitors will also send to the FCA a request to omit information under PRR 2.8.2. Any such request must clearly outline the specific information concerned and the grounds set out in PRR 2.8.1 (Article 18(1)) as previously mentioned. No information may be omitted unless the FCA consents.

**Liability for a prospectus**

**Persons responsible for the prospectus**

Section 84(1)(d) FSMA provides that the PRR are able to determine who is responsible for a prospectus. **PRR 5.3.5** provides that, amongst others, the following will be responsible:

· the issuer;

· each person accepting responsibility (and stated in the prospectus as doing so) for the prospectus (e.g. auditors accepting responsibility for financial information reproduced in the prospectus);

· any guarantor in respect of information relating to it and the guarantee; and

· any other person (not falling within the above categories) who has authorised any of the contents of the prospectus.

**Compensation for false or misleading statements or omissions in a prospectus**

**Section 90 FSMA**

This states that false or misleading statements or omissions in a prospectus can give rise to both civil and criminal liability. The main section dealing with civil liability of the responsible persons is s. 90 FSMA. Schedule 10 FSMAsets out a number of defences available to potentially responsible persons.

Section 90(1) in conjunction with s. 90(11) provides that any person responsible for a prospectus (i.e. under **PRR 5.3.5**) is liable to pay compensation to a person who has acquired bonds to which the prospectus applies and who has suffered loss in respect of those bonds as a result of any untrue or misleading statement in the prospectus or the omission from the prospectus of anything required to be included in it under FSMA.

There are **two main defences in Schedule 10 FSMA**:

· First, under paragraph 1, a person will not be liable for an incorrect statement if he reasonably believed that the statement was true and not misleading. There are a number of conditions which must be satisfied before this defence will apply, which are set out in paragraph 1(3).

· Second, under paragraph 3, a person will not be liable for an incorrect statement if he issued a correction and took reasonable steps to publish that correction. The detail of this defence is set out in paragraph 3(2).

Liability under s. 90 is very broad. In particular, s. 90 can be relied on by any person who acquired the securities, including subsequent purchasers as well as the original investors who bought from the issuer. As a result, investors are more likely to rely on s. 90 rather than other heads of liability to sue a responsible person (usually the issuer).

**Other heads of civil liability**

**These include:**

**negligent misstatement ( Hedley Byrne v Heller ):** but the investor would need to show a duty of care was owed to the investor, that the duty was breached and that the investor suffered loss as a result of the breach;

**misrepresentation:** can be fraudulent, negligent or innocent. To succeed, the investor would need to prove some form of reliance on the misrepresentation;

**breach of contract** (subscription agreement): only managers can sue the issuer for breach of the subscription agreement; and

**tort of deceit**: the investor would need to show intention to deceive on the part of the issuer.

All these courses of action will only be available to initial purchasers and as a result s. 90 FSMA is more likely to be used by investors. Any investor who has bought the securities and suffered a loss can sue under s. 90 FSMA. The investor need not have relied on the misstatement.

**Criminal liability**

This includes:

**Part 7 of the Financial Services Act 2012 (ss. 89-95)** sets out new criminal offences relating to financial services, such as making false or misleading statements and creating false or misleading impressions.

Additional offences are contained in **s. 19 Theft Act 1968** (False Statements by Company Directors) and **ss. 2** (Fraud by False Representation) and **3** (Fraud by Failing to Disclose Information) of the Fraud Act 2006.

**Summary**

· There are various elements that need to be considered when reviewing what content needs to be included in a prospectus.

· There are general statutory disclosure requirements which need to be adhered to alongside prospectus requirements such as document types and information that is required.

· When drafting a prospectus there are ongoing issues such as verification, annotation and final approval and other elements such as cross-referencing needs to be monitored and applied.

· Liability of a prospectus can be traced to persons who are responsible and can also lead to compensation being given for false or misleading statements and omissions.

· Civil and criminal liability is also possible.

**An introduction to structured finance**

This element introduces the concept of structured finance, focussing in outline on two examples (project finance and securitisation).

**Nature of structured finance**

Structured finance is **‘anything that is not plain vanilla’** finance. Whilst the term can mean different things to different people, we mean raising debt through a structure that has been customised to the needs of the borrower/issuer.

Structured finance is certainly more complex than plain vanilla lending/bond issues. A more advanced form of financing may be appropriate because conventional plain vanilla financing is unattractive, unavailable or too expensive in the circumstances. Within the category of structured finance, the level of complexity will vary depending on the financing needs of the borrower.

Structured finance transactions can involve both loan and bond financing. The additional considerations given to structured transactions as opposed to plain vanilla loan transactions will also apply where the structured financing involves the issue of a bond. These considerations include the undertakings and events of default, the structuring of the security package and the provision of guarantees.

Though not exclusively, use of derivatives is another feature of a structured finance transaction. A derivative is a financial contract whose value is derived from an underlying asset. That asset can be a security (e.g., a share or a bond), a commodity, a rate (e.g., an interest rate or a currency exchange rate), an index or any other tradable instrument.

Because of the nature of structured finance, it is common for derivatives to be used as part of the financing arrangements, primarily to protect against certain financial risks such as **fluctuations in interest rates or in currency exchange rates.**

This topic only amounts to an introduction to structured finance and derivatives. Transactions involving structured finance and derivatives have the capacity to be very complex and detailed knowledge of these transactions is outside the scope of this knowledge stream. However, with the basic knowledge provided here you will be in a good position to develop an understanding of the complexities of this area when you encounter such transactions in the workplace.

This element will firstly consider some typical features of structured finance transactions. Then, by way of example, this element will consider a project finance transaction (though you need to be aware there are other categories of structured finance transaction such as property finance, asset finance and acquisition finance).

This element will then give a brief introduction to another form of structured finance, securitisation. We will consider derivatives in the second element.

**Typical features of a structured finance transaction**

Whilst credit risk is involved in all forms of finance, structured finance can involve greater amounts of risk from different sources. The **credit risk evaluation needs to be thorough**. Market risk (whether the financed product or project will be attractive to the market and produce revenue), operating risk (risks that come with the operation of the product or project), environmental and political risk (including the risks of regime change and political intervention) are all examples of other risks that need to be considered as part of the due diligence process.

It is a common element of many forms of structured finance transactions that the entity raising the finance is a special/single purpose vehicle (**SPV**) (sometimes it is referred to as a special purpose entity or SPE or a Newco).

This is a company that has either been formed specifically for the purpose of raising the finance, or it has been formed specifically to carry out the transaction or operate the asset that is being financed. The shareholders or **‘sponsors’** of the SPV will generally be the entities wishing to raise the money involved.

In plain vanilla financing, we have already seen that potential investors (i.e.; lenders or bondholders) will carry out due diligence on the borrower to assure themselves that the pricing of the transaction reflects the risk of not being repaid. Part of this process involves looking at the assets held by the borrower and the recourse that the investors have to these assets in the event of the borrower defaulting.

In structured financing, if the borrower is an SPV, it will not have a financial track record and at the time of the financing, the SPV will usually own nothing.

Going forward, its only assets may be the assets whose purchase or construction is being financed. Further down the line, these assets may produce revenue. This revenue stream will be a further asset of the SPV and generally its only income stream with which to service the debt.

The credit analysis of a structured finance transaction will be very different to that of a plain vanilla financing. For example, a plain vanilla syndicated loan to an investment grade company will often be on an unsecured basis. The underlying principle is that the lenders are happy to rank pari passu with other creditors and they take their protection from the negative pledge restricting the borrower’s ability to create security.

This is far too simplistic for a structured finance transaction. The SPV borrower will often have few assets, and the lenders will want to ensure they have security over those assets and that they will rank ahead of any other creditors as far as possible.

If lending to an SPV is riskier for lenders (banks or bondholders), why does structured finance often use an SPV? **There are several reasons why SPVs are used**:

· commonly, there are tax advantages for using an SPV;

· it may be that the owner of the SPV is concerned about the risks involved in the transaction and wants no exposure beyond its equity contribution;

· for insolvency remoteness – because structured finance creditors do not want to have to compete for access to the assets owned by the SPV as they would have to do if lending to an operating business. Using a SPV ensures assets are 'ring-fenced';

· SPVs incorporated in other jurisdictions such as Ireland, the Netherlands and Luxembourg can often be associated with lower costs than English incorporated entities; and

· using an SPV gives the sponsors (and, following default, the financiers) the ability to sell the project by way of a share sale.

**Structured finance - Example**

Roadbuild PLC ('**Roadbuild'**) has won the bid to build and operate a toll motorway. This is considered to be a risky undertaking due to the possibility of cost overruns and insufficient public support after completion. As a result, Roadbuild’s shareholders would object if Roadbuild itself bore the risk. If Roadbuild forms an SPV to carry out the project, Roadbuild’s liability can be limited to the extent of any guarantees it gives to the lenders to the SPV. In the absence of any guarantees, its liability will be limited to the share capital it invests in the SPV.

This arrangement will satisfy Roadbuild’s shareholders. It will not satisfy the authority granting the concession (i.e., awarding the project) and it will need guarantees to be given to it. In addition, the lenders financing the project will need to be satisfied that the SPV will be able to complete the construction, and that the revenue will be sufficient to repay the interest and capital over the required time. They will also need to consider the impact of other creditors and the security and contractual arrangements they need to put in place to protect against such other creditors.

Finally, the lenders will want to consider the worst-case scenario. If the SPV fails to complete the project, can the lenders step in and finish the job? Without a completed motorway, the assets of the SPV are of no use to them. The lenders will want “step in rights” so another contractor can step into the shoes of the SPV and complete the project.

**Putting matters into context**

Everything you have learnt so far on this knowledge stream in relation to plain vanilla financing (loans and bonds) forms the heart of the more complicated forms of financing known as structured finance, some of which you may encounter during a finance seat. These arrangements will involve a loan agreement and/or a bond issue, security arrangements and issues of priority between investors (i.e., lenders and/or bondholders). These are all issues you have already encountered on this knowledge stream.

In a structured finance transaction, there is more emphasis on identifying specific **risks arising from the transaction,** which will be of concern to the various parties to the transaction. To deal with such risks there are likely to be more specific provisions in the finance documentation (whether it be loan or bond documentation), limited recourse (as mentioned earlier), more tailored security and guarantee arrangements and the use of derivatives to manage exposures to currency exchange and interest rate fluctuations which could affect the income stream needed to pay lenders or bondholders.

**Example of structured finance: Project finance**

Project finance is the financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure. The financing will include a mixture of debt and equity and the revenues from the project will be used to repay the debt. Projects involved in such financing include power, transport systems, roads, bridges, hospitals and prisons.

The Private Finance Initiative (**PFI**) provided a way of funding major capital investments without immediate recourse to the public purse. Private consortia, usually involving large construction firms, were contracted to design, build, and, in some cases, manage new projects. The term PPP (public/private partnership) describes any private sector involvement in public services including the transfer of council homes to housing associations using private loans and contracting out services such as rubbish collection or hospital cleaning to private companies.

This was seen as a way of introducing an element of private ownership to state-owned businesses (for instance through joint ventures) or contracting private companies to provide public services (including PFI). Although the government announced a few years ago that they would no longer use PFI, a number of PFI projects are still in operation and will remain so for some time.

**Project finance- transaction structure**

We will start with the **sponsors**. They are usually companies experienced in carrying out projects. Typically, the sponsors will form an SPV (also called the **project company**) and will be its shareholders. The sponsors will be responsible for promoting, developing and managing the project. The sponsors may have other roles in the project e.g., as lead contractor under the construction contract or as project operator under the operating contract.

The SPV will own and operate the project and act as the borrower from the lenders (banks or bondholders).

Under the terms of a concession agreement, the government, municipality or other public body (the **Concession Authority**) awards the SPV/project company a concession granting it exclusive ownership of an asset for a number of years. At the end of the concession, the SPV/project company may hand back the asset to the public sector. Before this happens, if all has gone well, the project company should have produced sufficient revenue from operating the project to have repaid the amounts owed to the lenders and to have paid dividends to the sponsors.

Project financing allows the Concession Authority to develop an infrastructure resource without committing funds to the project. This takes the financing “off balance sheet” which means the debt incurred to finance the project will not feature as part of government debt.

The lenders (under syndicated loans or bond issues) will not normally have recourse to the sponsors, the shareholders of the project company. The lenders therefore focus on the projected cash flow from the project and ensure that they have security over all the project company’s key assets. This underlines the fact that project finance is focused on repayment of debt out of cash-flow generation rather than relying on high value asset recovery.

The sponsors will invest equity into the SPV/project company and may also lend money to the SPV/project company via subordinated debt. The lenders will be the “senior” debt providers (either by way of loan or bond issue) which means they will have first rights to the assets of the project on default. Other lenders may rank as “junior” or “mezzanine” (mezzanine rank before junior and after senior lenders).

The mixture of debt and equity investment will vary from project to project. The sponsors will need to carefully consider the level of equity investment as the cost involved in financing through equity and debt will vary from project to project.

The lenders will want to see a comfortable level of equity in the SPV/project company. The more equity the sponsors invest in the SPV/project company, the greater their financial commitment to the project.

Historically, the debt finance in a project has been provided by bank lenders. Increasingly, bonds are being used to provide part of the debt financing. There are advantages and disadvantages for the sponsors in involving bond finance. The interest rate on bonds tends to be fixed, and bond maturities are generally longer than for loan finance.

Bond finance is also generally cheaper than loan finance, although the initial costs of raising the finance are greater.

The disadvantage of bond finance is its lack of flexibility compared to loan finance. Should the financial predictions for the project be wide off the mark in practice, it is easier to negotiate a variation to the transaction documents or restructuring where there is a borrower default with a syndicate of banks than an unknown body of bondholders.

It is possible to have a mixture of senior and subordinated loans and bond issues to finance the project. To do so increases the range of the transaction’s risk profile (lower to higher risk) and is done to attract a wider spread of lenders. In such a case, to negotiate a variation of the transaction documents or a restructuring will be especially challenging.

In some countries, the lenders may require the involvement of a multilateral agency such as the European Bank for Reconstruction and Development (**EBRD**) or the International Finance Corporation (**IFC**) (the private sector lending arm of the World Bank) to lend alongside them or to assume a variety of political risks such as failure of a host government to make payments or to provide currency exchange.

Without the involvement of such agencies in some projects, either the pricing may be too high or the lenders may refuse to be involved, particularly those located in emerging markets or weak economies. The lenders may also require sovereign guarantees from the host government or the financial support of export credit agencies.

Once the development phase (including construction) of the project is completed, the project moves on to the operational phase. At this point, the project will start to produce revenue and the financial risk of the project changes.

The Concession Authority may pay the SPV/project company a performance-related fee for operating the asset. The sponsors will often want to refinance the original debt on financing terms that reflect the lower risk of the project.

**Project finance- security**

Lenders will aim to take security over the asset developed and operated by the SPV/project company, the future revenue streams arising from the operation of the project and the shares in the project company.

The lenders will also take security over other the SPV/project company’s rights under key contracts. They will include the Concession Agreement, Construction Agreement, Supply Agreement, Purchaser Agreement and any licence to operate the project (e.g., from a government or public authority).

The lenders will want to sign Direct Agreements under which they have step-in rights under key contracts allowing them to take over the SPV/project company’s contractual rights and obligations if it defaults. The Direct Agreements are made between the lenders and the contract counterparties. They may also require the counterparty to give the lenders time to remedy any default by the SPV/project company or the project operator (see below) before they exercise their contractual termination rights.

As the lenders may have no recourse to the owners of the SPV/project company (i.e., the sponsor), the cashflow generated from the operation of the project will be the main source for paying interest and repaying principal on the debt.

**Project finance- documentation**

Key project documents include the following:

· **Concession Agreement/Licence/Project Agreement:** This is the contract between the Concession Authority and the SPV/project company granting the project company rights in relation to the project. It normally entitles the SPV/project company to build, finance and operate the project for a fixed period. The Concession Authority may pay the project company a performance-related fee for operating the project.

· **Shareholders’ Agreement:** If there are several project sponsors**,** they will enter into a shareholders’ agreement to regulate the relationship between the various project sponsors in their capacity as project company shareholders. If, in addition to the lenders, the sponsors are providing junior or mezzanine debt to the SPV/project company, then, if the lenders are party to the shareholders’ agreement, the agreement may include subordination provisions. The subordination arrangements could be agreed in a separate subordination agreement.

· **Construction Agreement:** The SPV/project company has few, if any, employees or resources and therefore, it will sub-contract its obligations to build the project to construction specialists and experts under construction agreements. They will usually be fixed price turnkey contracts where the contractor has to design and build the project in phases and the SPV/project company will pay it on completion of the contracted works (the idea being on completion, the SPV/project company can simply turn the key and the project will be fully operational and start to generate revenues which the SPV/project company will apply in repaying debt and ultimately in paying dividends to the sponsors).

The fixed price feature of the construction agreement is important to the lenders as they are keen to ensure that as much of the risk of cost overruns and late completion as possible is placed on the contractors. Such factors can otherwise disrupt the proposed servicing of the debt.

· **Finance documents:** There will be a credit agreement and/or bond issue documents depending on whether the project is to be financed by a loan or a bond issue. The lenders will not normally require any of the principal to be repaid during the construction phase. If a bond issue is used, more detailed undertakings and events of default will be included than would be found in a plain vanilla bond and a bond trustee will be appointed. The bond trustee will both monitor the project’s performance for the bondholders and enable these provisions to be waived.

**Project finance- finance documents**

Provisions that may be included in the finance documents include:

· a narrowly drafted purpose clause;

· representations from the SPV/project company covering the financial forecasts and full disclosure relating to the project;

· undertakings from the SPV/project company that none of the project documents will be amended, no dividends will be paid (with exceptions) to the sponsor(s) and the project company will carry on no other business;

· the SPV/project company will give detailed financial covenants;

· events of default will include nationalisation of the project, unfunded cost overruns and force majeure;

· comprehensive conditions precedent (including obtaining Secretary of State approval, if the project triggers a mandatory notification requirement under the National Security and Investments Act 2021); and

· mandatory prepayment of the facility using certain receipts such as any compensation paid to the SPV/project company.

**Project finance- documentation**

**Security documents**: Security agreements will create the security required by the lenders (i.e., over the project assets and the shares in the project company).

If the project is in the UK, taking a fixed and floating charge over all the assets of the project (whether held by the project company or project operator) will allow the lenders to appoint an administrative receiver provided that the project falls within s.72A to G of the Insolvency Act 1986 (the 'Act'). This section includes utility projects and other projects involving debt of at least £50 million. They are one of the exceptions to the prohibition of appointing administrative receivers introduced into the Act to allow lenders to applicable structured financings to continue to have the right to appoint administrative receivers.

**Intercreditor agreement:** There may be a separate intercreditor agreement, particularly if both a syndicated loan and a bond issue are providing the debt finance.

**Accounts agreements:** The SPV/project company will agree to ensure that its receipts are paid into certain accounts and the parties involved will agree the order in which payments will be made from them (**waterfall payments**).

**Supplier and Purchaser/Offtake Agreements:** The supplier agreements usually relate to the supply of energy to the SPV/project company or project operator. Under an offtake agreement, a buyer will, often over a long period, agree to buy the end product or service which the project produces. Supply and offtake agreements can be essential in securing project financing. If a continuous supply is required for a project to operate, such as fuel for a power station, a long-term supply agreement will guarantee that supply. For certain types of projects such as a power station, the lenders will want to know in advance who will be the purchasers and the basic terms (such as price) on which the purchases will take place. The amounts paid by the buyers will be a primary source of repayment of the debt financing.

**Operating and Maintenance Agreement:** We have referred already to the ‘project operator’. A SPV/project company will often appoint a project operator to manage and operate the project on its behalf. The project operator is often a subsidiary of a sponsor and its role is to ensure the project is properly run in accordance with the various project agreements and that the projected revenues are earned. The operating and maintenance agreement is made between the SPV/project company and the project operator dealing with arrangements during the operational phase. The lenders will wish to review the agreement to ensure that the operation and maintenance standards of the project will ensure that its ability to produce revenue is protected.

**An introduction to Securitisation**

Securitisations are very complex, high-value transactions involving many different variations on the basic structure. They will involve numerous parties, extensive documentation and, often, several jurisdictions.

Securitisation can be defined as “the sale of identifiable cash flows to an insolvency remote vehicle to secure securities (i.e., bonds), issued on the basis that recourse is limited to such cash flows and any related assets” or "a technique for raising finance from income-generating assets (e.g., loans) by redirecting their cash flow to support payments on a related issue of securities (i.e., bonds)".

Examples of cash flows/assets that have been securitised include credit card receivables, commercial and residential mortgage loans, student loans, football ground gate receipts and royalties from a musician’s back catalogue.

In a securitisation, a large company or financial institution (the originator) will pool a number of assets producing a cash flow (i.e., receivables) and procure the issue of a bond supported by those assets.

Usually, the originator sells the assets, most commonly by way of an assignment, to an SPV (owned by the originator) which will issue the bonds. The bondholders will only have recourse to these cash flows for payment of interest and principal on the bonds. An example is the securitisation of a portfolio of mortgage loans.

The mortgage lender sells (by assigning) its rights under a collection of domestic mortgage loans to the SPV. The SPV issues the bonds, relying on the cash flow from the mortgage loans to provide interest and principal payments on the bonds.

The issue proceeds from the bond issue are used to pay the purchase price to the mortgage lender. The SPV may create security over its assets in favour of a trustee for the benefit of the bondholders.

For the sake of simplicity, we have only described what is known as the true sale securitisation model in this element. You should be aware that this is only one example of a securitisation structure, and you may encounter other forms in practice.

There are three notable reasons as to why a company would wish to securitise a pool of assets:

The first reason lies in the ability of the originator to use the assets to raise finance at a better cost of funding than it would otherwise obtain. The originator will have a variety of liabilities and the credit rating of the pool of assets may be greater than the originator’s own credit rating (assuming that the assets are of a sufficiently high quality). The originator could itself issue debt secured on the future revenues, but it may achieve a better result for itself via a securitisation. This will happen if the interest payable on the securitisation bond is lower than the interest it would have to pay on bonds which it issued even though the assets in both cases are the same.

Secondly, it enables the originator to convert illiquid assets into tradeable capital markets instruments. This in turn also diversifies its funding sources.

Thirdly, securitisation allows the originator effectively to exit the mortgage lending market and allow other lenders to assume the risk of its lending portfolio.

Note this is only a basic introduction to securitisation which is a highly complex form of structured finance.

**An introduction to Securitisation - structure**

The SPV will be run so that it is, as far as possible, insolvency remote. Its only assets will be the securitised receivables. It will have no employees and will carry out no other business. The SPV may take a “liquidity loan” from the originator or a third party to ensure that it has access to funds other than the receivables. As such loans may give rise to increased regulatory capital costs, in the event of a liquidity shortfall, other options or increased reliance on cash reserves are sometimes explored.

The documentation will include a cash flow waterfall showing the order in which payments received by the SPV will be paid. Usually, transaction parties such as the trustee and the principal paying agent will be paid first. Thereafter, the bondholders will be paid in accordance with their ranking (senior, junior or subordinated) reflecting any issue of bonds in different tranches with differing payment priorities (these tranches will have different interest rates to reflect the risk that each bond tranche has). The liquidity loan will be subordinated in the waterfall to the bondholders. The waterfall may provide for surplus amounts to be paid to the originator as profit.

**An introduction to Securitisation- transaction issues**

**Parties:** The originator has been mentioned above. It is the entity (financial institution, large corporate etc.) that creates and sells the assets to the SPV. The originator may be responsible for continuing to service (i.e., collect) the receivables, but this will be done as agent for the SPV. Alternatively, a third party can play this role.

Where the pool of assets will fluctuate, a collateral manager will need to be appointed to manage the assets. The SPV may also appoint a collateral administrator, whose duties will include obtaining valuations of the assets.

As a secured bond will be issued, a trustee will be appointed (to hold the security) and a paying agent(s).

**Security:** Key in the security due diligence will be ensuring that there are no restrictions on assigning the receivables to the SPV. Such restrictions do not prevent the securitisation, but they will add a layer of complexity. The assignment from the originator to the SPV may be notified to any underlying debtors. Alternatively, the only notification to the debtor may be that payment should be made into a specific account, which is charged to the trustee and operated as a blocked account.

**An introduction to Securitisation - documentation**

· **Security agreement:** The SPV will grant security to the trustee on behalf of the bondholders over the receivables and any other assets of value such as the benefit of the swap agreement and any bank accounts.

· **Legal Opinions:** The legal opinions for a securitisation are more detailed than those for other loan arrangements. The transactions are generally far more complex and the opinions will address tax issues and whether the assignment of the receivables is a true sale transaction.

· **Liquidity loan agreement: T**his may be provided by the originator or a third party to the SPV.

· **Bond documents:** Subscription agreement, trust deed, principal paying agency agreement and offering document. The bond may be admitted to trading or offered as a private placement.

· **Servicing agreement:** Covering such issues as the collection of the receivables and the treatment of defaulting debtors.

· **Sale agreement:** This will set out the terms of the sale from the originator to the SPV. It will set out the representations and warranties the originator makes regarding the receivables.

· **Swap agreement:** The SPV may be required to hedge any interest rate, currency or other exposure.

**Summary**

· Structured finance is **‘anything that is not plain vanilla’** finance. Whilst the term can mean different things to different people, we mean raising debt through a structure that has been customised to the needs of the borrower/issuer.

· A more advanced form of financing may be appropriate because **conventional plain vanilla financing is unavailable**

· Examples of structured finance transactions include project finance and securitisation.

· A securitisation in basic terms involves the sale of a pool of income-generating assets to an SPV. The SPV funds the purchase of the assets through a bond issue and payments under the bonds are funded through the cashflows generated by the income-generating assets.

**An introduction to derivatives**

This element introduces the concept of derivatives and how they may be used for hedging against certain risks.

**Derivatives-nature**

**features, regulation and documentation**

A derivative is a contract whose value derives from an underlying asset. Derivatives may be traded on an exchange or over the counter (**OTC**). Exchange traded derivatives are beyond the scope of this knowledge stream. Derivatives can be used to make money (investment) or to protect against specific financial risks (hedging).

When included as part of a financing transaction, derivatives are often used for hedging purposes as lenders may insist that as part of the transaction the borrower hedges against certain risks.

The main trade association for the derivatives market is the International Swaps and Derivatives Association Inc. (‘**ISDA**’). Amongst its functions, ISDA produces standard form documentation for derivatives transactions to standardise and minimise the documentation required for the derivatives market.

The main document to be aware of is the ISDA Master Agreement which contains market standard terms. It is accompanied by a customised ‘Schedule’ which amends the standard terms in the ISDA Master Agreement for a particular transaction.

**Derivatives- structure**

This knowledge stream provides only a brief introduction to derivatives and the more common forms of derivatives.

Derivatives are extremely flexible with products capable of being tailored to cover all sorts of risks from stock market volatility to changes in the weather. Bankers are constantly devising new products and it is an area riddled with jargon.

The most common forms of derivatives are swaps (such as interest rate swaps, currency swaps and credit default swaps), options, forwards and futures. As far as swaps are concerned, the detail of how a swap operates (see below) is **not** examinable. This information is included in order to assist your understanding of the concept of a swap.

You do, however, need to be able to **identify**

**Interest Rate Swap**

In an example of an **interest rate swap**, A Ltd is a property company that has borrowed £10million from Bank Z to construct office premises. A Ltd is paying interest on the loan with Bank Z at the rate of SONIA (which is a floating rate but is presently 2%) plus a margin of 2% and the loan is repayable in 3 years. The building has been fully let for the 3 years at fixed rental rates. The rental income (which represents 6% of the £10m value of the property) is £600,000 per annum. A Ltd believes that interest rates will fall but it is exposed to a rate increase. If SONIA goes up to 4% or above, A Ltd will not have sufficient rental income to pay all the interest on the loan. A Ltd needs to swap its fixed rental income for a floating rate income to match its floating rate liability, i.e., the interest it will have to pay to Bank Z.

To address this interest rate risk, the borrower, A Ltd, can **purchase an interest rate swap**. A Ltd agrees to pay the swap counterparty (i.e., a hedge bank) a fee for entering into the swap. Under the swap agreement, (i) A Ltd agrees to pay the swap counterparty interest fixed at 6% on a notional loan of £10m on a specific date and (ii) the swap counterparty agrees to pay A Ltd interest at SONIA plus 2% on that specific date also on a notional loan of £10m. The £10m loans are notional because neither A Ltd nor the swap counterparty lend that (or any other) sum to the other.

The interest payment dates under the swap will be set to coincide with the dates on which A Ltd has to make interest payments to Bank Z. Note that, on each payment date, only one party under the swap agreement will make a payment to the other. A Ltd and the swap counterparty will set off the payment that each has to make to the other leaving one party with an obligation to pay the difference to the other. For example, if, as a result of a rise in interest rates, the swap counterparty has to pay £150 to A Ltd (let us say, up from £100) under the floating rate loan and A Ltd must pay interest of £100 to the swap counterparty under the fixed interest rate loan, the £150 is set off against the £100 and, after the set off, the swap counterparty must pay £50 to A Ltd. The additional sum which A Ltd receives from the swap counterparty is counterbalanced by the increase in the interest A Ltd must pay to Bank Z under its floating rate loan.

The person making the payment after the set-off is said to be**out-of-the-money** on the swap; the party owed money after the set-off is **in-the-money**.

Let us now suppose that interest rates fall, and the swap counterparty must now only pay £90 to A Ltd under the floating rate loan but A Ltd must still pay £100 to the swap counterparty under the fixed interest rate loan. In this situation, after set-off, A Ltd must pay £10 to the swap counterparty. Although A Ltd is out-of-the-money and has a new liability of £10 which it did not have before, the payment it makes to the swap counterparty will be counterbalanced by the reduction in the interest payment A Ltd has to make to Bank Z under its floating rate loan.

**Interest Rate Swap**

*Diagram: Arrow from Hedge Bank labelled “Floating Rate” to A Ltd; Arrow going the opposite way with “Fixed Rate.” Arrow from A Ltd to* *“Floating Rate Interest;” Arrow to A Ltd labelled “Fixed Rate Rental Income.”*

**Currency Swap**

In a currency swap, currencies of payment can be swapped. Currency swaps can allow entities to reduce their cost of funding. For example, a German borrower may wish to borrow in US dollars but may not be able to get as favourable a rate of interest on the loan as a US borrower could.

Similarly, a US borrower may wish to borrow Euros but may not be able to get as favourable rate of interest on the loan as a German borrower could. A currency swap can allow the two borrowers to borrow in their domestic currencies and then swap their loan amounts and interest commitments to allow each to get their required foreign currency at an advantageous interest rate.

Equally a group of companies may earn the lion’s share of their income in one currency (e.g. Euro) but have found the best borrowing rate to be through their UK subsidiary via a sterling loan. A lender may require the group to hedge against the risk of exchange rate fluctuation in the value of sterling and euro.

**Currency Swap**

*Diagram:*

*Arrow from “Hedge Bank” to “Borrower” labelled £ Payment; Arrow in opposite direction labelled € payment*

*Arrow from “Bank” to “Borrower” labelled £ Loan; Arrow in opposite direction labelled £interest.*

*Arrow from “Borrower Group” to “Borrower” labelled € income.*

**Derivatives - risks**

There are three main risks involved in derivatives:

· Credit risk – i.e. the solvency of a party involved.

· Settlement risk – if one party fails to make a payment leading to a potential default for the counterparty.

· Market risk – for example, an adverse movement in any relevant market.

**Summary**

· Derivatives are commonly used in structured finance transactions to hedge against specific risks, in particular fluctuations in interest rates and currency exchange rates.

· This is achieved by using interest rate swaps and currency swaps.