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Banknotes

Highlighting developments and issues in the finance industry

Welcome to the Winter Edition of Banknotes

In the previous edition of Banknotes we noted that the preceding months had been a turbulent time for the credit markets. Looking back now, following the events of the autumn, it is clear that those turbulent times are still with us. In this edition of Banknotes, we look at the questions being raised about the accuracy of LIBOR as a benchmark and reflect on some recent cases and developments in the market.

Winter 2008

In this issue:

LIBOR — Weathering the Storm?

"LIBOR has stood the test of time: it has been published on every business day since 1985 and is among the most transparent indices in the world. These changes will further strengthen LIBOR and the confidence of its many users."

With these words, the chief executive of the British Bankers' Association ("BBA") introduced the BBA's proposed changes to the governance and scrutiny of LIBOR in response to the credit crisis. Throughout the credit crisis LIBOR has acted as a barometer, rising and falling in response to the liquidity (or otherwise) of interbank funding, but market participants have questioned the accuracy of LIBOR as a benchmark suggesting that the true cost of funds was significantly higher.

The BBA has attempted to address these concerns by announcing a tightening of the governance of the LIBOR rate-setting process by a series of measures including (1) a greater scrutiny of the rates contributed by banks in order to enable the various LIBOR rates to be set; (2) widening the membership of the independent committee of market participants responsible for overseeing the process by which LIBOR rates are set; and (3) potentially increasing the number of contributors to certain of the rate-setting panels.

Having sought feedback from market participants, the BBA produced a further statement. The BBA noted that the feedback was largely supportive of the BBA's proposed changes although it was noted that whilst larger contributor panels were supported, no new banks had yet offered to contribute. Responses were also sought as to whether a greater degree of anonymity for contributing banks would lead to more accurate rates being set.

The majority view was that great anonymity would be a retrograde step and that any discrepancies could be dealt with by the tighter scrutiny and governance processes which had already been agreed upon.

LIBOR continues to be under pressure however. In a further indication that certain market participants consider LIBOR to be fractured from true bank funding costs The Financial Times reported at the end of September that some borrowers were finding that their lenders were invoking the "market disruption" provision that features as a standard in most loan agreements in order to enable them to pass the rising costs of funding to their borrowers. The BBA has urged caution in invoking such clauses as it fears doing so will exacerbate already difficult market conditions whilst at the same time noting that it will delay publication of its final report on the governance and scrutiny of LIBOR. The delay further highlights market turmoil and continues the pressure on LIBOR.

Whilst the credit crisis continues and banks find it increasingly difficult to raise funds on the interbank markets, LIBOR is likely to remain under strain and it remains to be seen how LIBOR reacts to recent cuts in the base rate of the Bank of England. However, given the widespread use of LIBOR as an index— the BBA estimates that it is used worldwide to set rates for financial products worth in excess of $350 trillion—any changes will have to be very carefully thought out. In the words of the BBA "there will be no knee jerk change and no alterations without clear rationale". ■

Pre-Packed Administrations Tested in Court

So called 'pre-packed' administration sales are, increasingly, the restructuring tool of choice. However, pre-packs are not recognised or referred to in the insolvency legislation and, up to now, there was a dearth of case law dealing with them.

In the case of *DKLL Solicitors -v- HMRC [2007] EWHC 2067* the High Court validated the pre-pack as a rescue tool, giving weight to the expertise and experience of the appointed insolvency practitioner.

In a pre-pack the terms of sale of a business are negotiated and agreed prior to the implementation of a formal insolvency process, usually administration. The transaction is then completed by the administrator immediately after his appointment. The advantages are that the business can be marketed and a buyer secured outside the insolvency process, which usually maximises realisations. Once a debtor is in an insolvency process the value of the business (especially goodwill) will quickly dissipate. Pre-packs have been criticised for their lack of transparency, since the sale is completed before the creditors have an opportunity to consider the merits of a sale or the administrator's proposals generally.

The DKLL Solicitors case related to an insolvent solicitors' partnership that owed in excess of £1.7m to HMRC, its majority creditor. HMRC had commenced winding-up proceedings against the partnership.

The two equity partners of the firm applied to court for an alternative administration order, arguing that this would achieve a better result for creditors than on a winding-up. The applicants argued that potential investors were interested in acquiring the business assets of the partnership through an administration sale and that an offer had been received for £400,000. The applicants estimated that, if the partnership was put into liquidation, realisations from a forced sale would be only £105,000, primarily because work in progress with a book value of £806,000 would achieve minimal realisations. Moreover, preferential claims by employees would be triggered on liquidation.

HMRC disagreed with the valuations. It also argued that, as the majority creditor, its views should hold sway. After all, if the administrators' proposals were put to a meeting of creditors, HMRC would have a sufficient majority to defeat such proposals.

To rebut these arguments, the applicants commissioned a report from insolvency practitioners with historic expertise in advising and assisting partnerships in cases of insolvency. The report concluded that a pre-pack sale out of administration would achieve the best results for the creditors as a whole. The report corroborated the applicants' argument that a liquidation would put work in progress and the partnership's goodwill at risk.

The Judge found in favour of the applicants. In reaching his decision, he was particularly influenced by the fact that the proposed sale would save the jobs of approximately 50 employees, cause minimum disruption to the affairs of clients and maximise the value of the partnership's assets and goodwill for the benefit of creditors. The Judge placed great reliance on the expertise and experience of the reporting insolvency practitioner.

The case confirms that the court will always place great weight on the position of stakeholders, employees, clients and others interested in the affairs of a distressed business. Whilst a court will respect and listen to objections from a majority creditor, this decision establishes that a majority creditor does not have an automatic veto on the implementation of an administrator's proposals in circumstances where the court believes there is a real prospect that the statutory objective of administration can be achieved.

Recent Cases

Promisor's obligation is a guarantee

The recent case of *Associated British Ports v Ferryways NV & Another* [2008] EWHC 1265 serves as a salient reminder that where a guarantor supports a primary obligation owed by one party to another, any variation of the primary obligation will discharge the guarantor from his obligations, unless the guarantor consents to such variation. Here, Associated British Ports ("ABP") provided loading services to Ferryways NV for a fee. Ferryways' obligations under this contract were guaranteed by its sister company, MSC Belgium NV ("MSC"), by a letter agreement. The original contract was subsequently amended so as to allow Ferryways additional time to make payments. Following Ferryways' insolvency, ABP sought to recover monies owed by Ferryways from MSC under the letter agreement.

As the letter agreement did not contemplate the subsequent amendment to the original contract, the court held that the guarantee did not operate in respect of the amended contract. The court held that it would take clear words for a guarantee to continue to operate where the contractual terms had been amended subsequent to the execution of the guarantee. Any amendment to the terms of the contract between ABP and Ferryways which could prejudice MSC altered the nature of the risk undertaken and MSC was therefore entitled to decide whether or not to continue to be bound by the guarantee.

The court held that it would take clear words for a guarantee to continue to operate where the contractual terms had been amended subsequent to the execution of the guarantee.

Although the court doubted the justice of the finding, it held that it was undisputed law that a guarantor is discharged when the creditor, without his assent, gives extra time to pay to the principal debtor. (Guarantees to banks ordinarily expressly state the contrary). MSC therefore escaped liability under the guarantee in circumstances where it had suffered no detriment from the amendment to the original contract.

Receiver's discretion on method of sale

The recent case of *Bell v Long* and others [2008] EWHC 1273 considered the discretion available to a receiver when deciding the method of sale of properties in order to repay the indebtedness owed to the mortgagee.

Mr Bell was a director and majority shareholder in Dimple Property Limited ("Dimple") which owned four freehold properties charged in favour of HSBC. Following a demand for repayment of sums owed by Dimple, HSBC appointed certain of the defendants as administrative receivers of Dimple. Having received individual offers for three of the four properties, the receivers subsequently sold the four properties as a portfolio for £775,000 on the advice of their appointed estate agents. Mr Bell alleged that in disposing of the properties as a portfolio after a short marketing period rather than individually, the receivers had failed in their duty to obtain the best price then reasonably obtainable for the properties in the open market.

The court acknowledged the inherent conflict in this scenario between the interests of a mortgagee in an early sale and of the mortgagor in a longer period of marketing

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and a potentially larger return but held that the mortgagee and receiver had to be allowed a degree of latitude as to the timing and method of the sale. In addition, the court held that the mortgagee could have regard to their own interests in deciding how and when to sell.

Given the facts of the case and the uncertainties in the market at the time of the sale, the court agreed that the receivers could not be expected to postpone a sale of the portfolio in the hope of obtaining a better price either for the portfolio as a whole or individually and that the decision to sell the properties as a portfolio was justifiable. For an allegation of negligence to succeed it was not sufficient to show, with the benefit of hindsight, that an alternative strategy could have produced a higher return.

The receivers had a competitive bid for the properties as a portfolio in excess of the combined total of the individual offers and had not failed in their duty to act in good faith and deal fairly and equitably with the mortgagor.

Comment

Receivers are effectively in the same position as mortgagees in that they owe a duty to all those interested in the equity of redemption to obtain a proper price for the property. Receivers can, however, be assured that they are permitted a certain amount of leeway when they decide the method by which to sell mortgaged property to realise a debt and that they are not under any obligation to wait for a higher offer for each individual property when a competitive bid for a portfolio has already been received. ■

New Members of the Team

We are pleased to announce that Claudia Harrison and Katie Hillier have joined the London finance team on their qualification in September 2008. Both Claudia's and Katie's training included time within the finance group as well as working for banks and a range of corporate clients in the real estate and corporate departments.

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