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Banknotes

Highlighting developments and issues in the finance industry

Welcome to the Summer Edition of Banknotes

Current economic conditions mean that enforcement and litigation loom larger on the horizon than they have done in recent years. With this in mind, in this edition we consider hidden liabilities for banks on enforcement, the differences between guarantees, indemnities and other sureties, and recent case law suggesting that banks may find it tough to get pre-action disclosure. We also look at the end of voluntary regulation of retail banking and a consultation on reform of U.K. insolvency procedures.

Summer 2009

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Hidden Liabilities on Enforcement

As the number of borrowers struggling to find tenants for their properties, and consequently defaulting on loans, increases, many banks will be contemplating enforcing security over an unoccupied property. One of the risks involved is liability to pay rates on the property. This liability falls upon the 'owner' of a property, which is defined as the person 'entitled to possession' of it. 'Entitlement' is the key element of this term; it does not necessarily mean the person is physically in possession. Prior to enforcement, the borrower will be the 'owner' of unoccupied property for rating purposes and, in most cases, such entitlement remains with the borrower despite enforcement of security and therefore banks should not risk incurring liability for rates. However, there is one situation where rates could be a hidden liability for banks on enforcement.

There should be no risk of a bank being liable for rates:

- if a receiver is appointed;
- if a liquidator or administrator is appointed without a receiver first being appointed; or
- if a bank appoints a receiver and the borrower subsequently goes into administration.

There is a risk that a bank may be liable for rates if it appoints a receiver and the borrower subsequently goes into liquidation. Unlike administration, a receiver may continue to act after a liquidator has been appointed, but can no longer be the borrower's agent. The receiver will continue to exercise powers over the unoccupied property, including taking possession of it, but he will no longer be able to rely on the fact of his agency to shield him from liability for rates. Whether this means that the receiver, or the bank who appointed him, becomes the person 'entitled to possession', does not appear to have been decided in the courts. Were the receiver to be liable, such liability would probably be passed on to the bank as the receiver is likely to have required them to indemnify him upon his appointment.

Considering the rationale behind unoccupied non-domestic property rates, it would seem illogical if a receiver or a bank were judged liable for rates. Liability falls upon the person 'entitled to possession' to prevent unoccupied properties escaping liability for rates simply because they are unoccupied. The phrase was probably not intended to catch liquidators, administrators or receivers, as illustrated by the exemptions which apply wherever the person 'entitled to possession' is a company in liquidation or administration. The unique situation where a receiver may continue to act once a company is in liquidation is a 'grey area', where there is a risk that a court may conclude that a receiver or a bank is the person 'entitled to possession' for rating purposes. ■

Guarantees, Indemnities & Letters of Comfort

A lender can take various assurances from third parties in respect of a borrower's performance of its obligations:

- A guarantee is a promise from a third party to fulfill the obligations of another if that other fails to do so. It is contingent and is therefore a secondary obligation, liable to be discharged by variations to the original obligations if made without the guarantor's consent.
- An indemnity is a promise from a third party to satisfy the obligations of another, but is not contingent upon, and is enforceable independently of, the original obligations to which it relates. It is therefore not at risk of being discharged by variation of the original obligations.
- Letters of comfort are written assurances which vary in form and substance from case to case, which may or may not be legally binding.

The differences between various types of third party assurances set out above mean that whenever a bank takes such an assurance in respect of a borrower's obligations, it is in all parties' interests to ensure that the nature of that assurance is clearly set out in whatever document constitutes the assurance, as highlighted by the Court of Appeal in Associated British Ports v Ferryways NV & Anor ([2009] EWCA Civ 189).

In ABP v Ferryways, the defendant ran ferry services and contracted with the claimant to receive loading and unloading services in return for fees. ABP received a letter from MSC Belgium NV ("MSC") (of the same corporate group as Ferryways) stating that MSC would ensure that Ferryways would "at all times" have enough funds and resources to meet its liabilities under the contract and that Ferryways would meet its liabilities under the contract when they fell due. When a payment dispute arose ABP gave Ferryways more time to pay. MSC's consent to this amendment was not sought. Ultimately, ABP brought proceedings against Ferryways and against MSC under the letter.

ABP argued that MSC's letter was an indemnity, or other contract imposing a primary liability on MSC. ABP emphasised the words "at all times" as evidence that MSC's liability was not contingent upon Ferryways' failure to meet its liabilities and therefore could not be a guarantee.

The Court of Appeal disagreed with ABP's arguments, finding instead that the nature of MSC's obligation was that of a guarantee, because the letter framed MSC's obligations by reference to Ferryways' obligations under the original contract. As a result, MSC was discharged from any liability under the letter by the extension of time given to Ferryways to which it had not consented.

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Comment

The case illustrates the importance of ensuring that all parties are aware of the nature of their obligations, especially when set out in a less formal structure, such as a letter. It highlights the risk posed by ambiguous drafting that assurances received by a bank or other beneficiary may be worthless if and when it needs to call upon them. It also demonstrates the importance of obtaining a guarantor's consent to variations to a guarantee and, wherever possible, combining a guarantee with a primary obligation such as an indemnity, which will be done in most bank guarantee documents. ■

Blow For Banks Seeking Pre-Action Disclosure

Current market conditions are resulting in more disputes between banks and other financial institutions. A prospective claimant may reduce the risk and cost of litigation by seeking pre-action disclosure from the prospective defendant. If such disclosure is not given voluntarily, a prospective claimant can apply to court. This was the course taken by Anglo Irish Bank in a case that was heard in February 2009.

The underlying claim arose from West LB's sale of US$55,625,000 of derivative instruments to Anglo. These derivatives, the "LSS Notes", were linked to another note issue, the "BH2 Notes".

It was alleged that West LB had represented to Anglo that the BH2 Notes, and therefore the LSS Notes, would be redeemed by the end of March 2007. Further, that even if the BH2 Notes were not redeemed, West LB would buy back the LSS Notes at par. In the event, the redemption of the BH2 Notes was revoked and West LB declined to buy back the LSS notes. As a result, Anglo incurred a US$ 42.74m loss. Anglo hoped to pursue a claim against West LB for negligent misrepresentation.

Anglo sought pre-action disclosure of communications between West LB and the BH2 note-holder relating to the early redemption of the BH2 Notes. This went to West LB's knowledge of the note-holder's intentions at the material time. Anglo also sought communications within West LB regarding the repurchase of the LSS Notes. Both these categories of documents were central to the strength of Anglo's case.

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The Court was not persuaded that this was an appropriate case for pre-action disclosure. The fact that the parties were financial institutions was significant. The Court noted that deals in financial instruments are often entered into between institutions with relatively limited documentation but conversations are taped.

In this case, the tapes were sufficient to enable Anglo to plead its claim. The Court thought it would be rare to order pre-action disclosure by one of the institutions of its internal documentation relating to the deal. It was one thing to require mutual disclosure during proceedings, but another to impose disclosure on one party before proceedings began. The Court also doubted whether the disclosure sought would really resolve the merits of the case, considering that it might only raise more questions.

Comment

On the basis of this case, claimant banks will find it more difficult to obtain pre-action disclosure against other banks and financial institutions. Claimant banks will need to rely on the evidence in their own hands when conducting a risk benefit analysis before commencing proceedings. Defendant banks will have the comfort of knowing that they are less likely to have to provide disclosure on a pre-action basis. ■

End of Voluntary Regulation of Retail Banking

On 1 November 2009, the voluntary banking codes which currently regulate the U.K.'s retail banking sector will be replaced by compulsory regulation in the form of the FSA's retail banking conduct of business sourcebook ("BCOBS") which will apply, among others, to U.K. authorised banks and building societies. Firms subject to BCOBS will need to ensure that their internal and customer facing processes and documents are compliant, ideally before 1 November, because the FSA has indicated that only a very limited transitional period will be allowed. The replacement of a voluntary regime with compulsory regulation should provide consumers with greater certainty about the retail banking services they use and the comfort of knowing that the FSA has greater power to impose dissuasive punishment on non-compliant service providers than the current Banking Code Standards Board. However, BCOBS will only apply to current and savings accounts. Credit products will continue to be regulated by the OFT, but it is not clear whether those parts of the banking codes relating to consumer credit will continue to have effect and, if so, how they will be enforced. ■

Consultation on U.K. Corporate Insolvency Procedures

On 15 June 2009, the Insolvency Service published a consultation paper proposing certain changes to U.K. corporate insolvency regimes, inviting responses by September. The proposals seek to promote the use of company voluntary arrangements (CVAs) and help companies in CVA or administration to find finance to assist their rescue. The proposals include:

- the extension of CVA moratorium provisions, which are currently only available to small companies, to all companies;
- introducing a general moratorium (maximum 3 months) available on application to court by any company that cannot pay its debts as they fall due, designed to provide companies with time in which to formulate CVA proposals in the knowledge that creditors cannot take action against them;
- allowing companies in CVA or administration to create fixed charges over their assets in order to obtain 'rescue finance'. Depending on the terms of the 'rescue finance', new charges may be subordinate to existing security, rank alongside it, or in priority to it. The consent of lenders holding existing charges would be required, or, if such consent is not forthcoming, a court order overriding the lender's objections; and
- limiting the assets caught by floating charges and asset based lending agreements to assets acquired before insolvency. ■

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