Linklaters

Banking update

Bank lending clauses favouring "Big Four" auditors likely to come under scrutiny

In its "Plan for Growth", published on 23 March 2011 as part of the 2011 Budget, the UK Government called on the OFT to investigate whether clauses in lending agreements made by banks, which make loans to businesses contingent on their audits being undertaken by the top tier audit firms, are restricting competition in the audit market. The concern is that such clauses may help to entrench the dominance of the "Big Four" auditing firms and have the effect of excluding smaller auditors from the market. The Government has called on the OFT to investigate whether such clauses exist, whether they unfairly and inappropriately restrict competition and whether their removal would mean that the next tier of audit firms would be better placed to compete for larger audits and lead to a more vibrant market for audit services.

The European Commission recently published a green paper, entitled "Audit Policy: Lessons from the Crisis", which also expresses concerns over the dominance of the "Big Four" audit firms and the potential systemic risk and resulting chaos in the financial markets should one of those firms fail (as happened following the collapse of Arthur Andersen, which formerly made up an auditing "Big Five").

This suggests that an investigation is almost inevitable, and OFT spokesperson Frank Shepherd confirmed on 23 March 2011 that the OFT is interested in the area of bank covenants and has already undertaken the initial steps into scoping for a potential market study into this area, subject to OFT board approval, which is likely to make a decision in April.

Nicole Kar and Marcus Blacker, London

Contents

Changes to U.S. withholding tax regime

Two recent legislative developments have changed the withholding tax landscape in the United States. First, Congress, concerned with U.S. taxpayers using accounts at foreign financial institutions and interests in non-financial foreign entities to avoid U.S. taxes, enacted a new withholding tax on payments made to those entities unless they enter into an agreement with the U.S. Internal Revenue Service ("**IRS**") and agree to report certain information on account holders or owners. Second, Congress clarified that fees paid for guarantees of U.S. obligations are subject to U.S. withholding tax.

FATCA

In June 2010, Congress enacted the Hiring Incentives to Restore Employment Act of 2010 (the "**HIRE Act**"). The HIRE Act contains rules imposing a 30 per cent. withholding tax on certain payments to foreign financial institutions ("**FFIs**") and non-financial foreign entities ("**NFFEs**") unless:

> in the case of an FFI, it enters into an agreement with the IRS and agrees to disclose information about its account holders; and

> in the case of an NFFE, it provides information about its substantial U.S. owners.

The HIRE Act provisions were originally contained in a separate piece of legislation, the Foreign Account Tax Compliance Act of 2009 ("**FATCA**"), and that name is still used to refer to the new withholding tax provisions. The statutory provisions of FATCA delegate much of the implementation of the new rules to the IRS. In August 2010, the IRS released the first guidance under FATCA in the form of Notice 2010-60. Although more guidance is expected before the FATCA rules take effect, the Notice represents a significant effort to clarify some open questions.

Definitions

The 30 per cent. withholding tax applies to "withholdable payments" to FFIs and NFFEs unless they agree to certain reporting obligations. Withholdable payments include interest, dividends and the gross proceeds from the sale of property that produces interest or dividends. The term also includes interest on a deposit with the foreign branch of a U.S. bank. This interest would normally be foreign source and not subject to U.S. withholding tax.

The term FFI is defined broadly and includes any entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) holds financial assets for the account of others as a substantial portion of its business, or (iii) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities. This broad definition includes investment vehicles such as hedge funds and private equity funds. Under the broad statutory authority granted to the IRS, the Notice identifies certain types of entities that are not treated as FFIs. The list includes certain:

> holding companies (although importantly, not investment funds or entities that hold subsidiaries that are financial institutions);

> hedging/financing centers that service groups that do not include a financial institution;

> foreign retirement plans (that generally do not allow U.S. participants or beneficiaries);

> insurance companies (if their products are limited to insurance contracts without cash value);

> non-financial entities that are liquidating or in the process of reorganising pursuant to a bankruptcy; and

> start-up companies.

In addition, certain other entities that are owned by a small number of individuals are "deemed compliant FFIs" if they provide information regarding their owners to withholding agents that pay U.S. source income to them.

NFFEs are non-financial foreign entities that are not required to enter into an agreement with the IRS, but must report to withholding agents their substantial U.S. owners. The notice exempts certain NFFEs from this requirement. Exempted NFFEs include publicly-traded companies and their affiliates, entities owned by foreign governments, international organisations and central banks.

Compliance

FATCA requires FFIs to undertake significant due diligence and reporting obligations to avoid the 30 per cent. withholding tax. The extent of the diligence and reporting will depend on the identity of the account holder. The first level of enquiry is whether the account is held by an individual or an entity.

For an individual, the FFI will need procedures to collect the appropriate forms to determine whether the account is a U.S. or foreign account. The Notice provides that only accounts held by an individual with an aggregate balance of at least $50,000 need be reported. This means that the FFI need a mechanism for identifying accounts that need to be aggregated as well as procedures for identifying account holders.

The reporting for accounts held by entities is more complex since these accountholders must be sorted into eight separate categories: (i) U.S. entities; (ii) participating FFIs (that have a reporting agreement with the IRS); (iii) deemed-compliant FFIs (that are excused from the requirement of an IRS agreement); (iv) non-participating FFIs (are required to have, but do not have, a reporting agreement with the IRS); (v) excepted FFIs (are excluded from the requirements of FFI reporting, i.e., holding companies); (vi) recalcitrant entities (entities that fail to provide necessary documentation to the FFIs with whom they have accounts); (vii) NFFEs (described above); and (viii) excepted NFFEs (are not required to report their substantial U.S. owners, i.e., publicly traded companies).

The Notice sets out detailed rules containing presumptions regarding the status of existing and new accountholders, and information that must be obtained to overcome those presumptions.

The Notice is only the first step in the guidance process. The IRS is expected to issue additional guidance in anticipation of the effective date of the legislation.

Allocation of FATCA risk

There is still some time before the FATCA provisions take effect, as payments on obligations outstanding on 18 March 2012 are not subject to withholding under the HIRE Act. The Notice clarifies that this exemption does not cover an obligation that is treated as equity for U.S. tax purposes, or that lacks a definitive expiration or term (such as a checking or savings account). Moreover, a material modification of an obligation after 18 March 2012 may result in the obligation being treated as newly issued on the date of the modification, causing it to lose grandfathered status. Further, there is an open question whether FATCA applies to an extension of credit after 18 March 2012, under a revolving facility that was signed prior to that date.

Accordingly, there is a risk is that a non-U.S. lender on a loan made under such a revolving facility may become subject to withholding tax if it does not comply with the reporting requirements of FATCA. Because this risk is in the control of the non-U.S. lender, U.S. borrowers have begun allocating the risk to the lender. The risk allocation has generally taken the form of a carve-out from the general withholding tax gross-up for any withholding taxes imposed under FATCA. However, lenders should be cautious in accepting this risk and should ensure that any carve-out only applies to FATCA as in effect on the date the loan closes and does not take into account later changes to the statute.

Guarantee fees

In an effort to overturn the result of an earlier Tax Court decision, Congress enacted a new sourcing rule for amounts received, directly or indirectly, from U.S. residents and corporations for the guarantee of any indebtedness of such resident or corporation. Under the new rule, these fees are treated as U.S. source payments and thus subject to 30 per cent. withholding tax unless treaty relief is available. The new rule also treats as U.S. source fees paid by any foreign person for the provision of a guarantee of any indebtedness of such person, if the fee is connected with income which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

Neither the statute nor its legislative history define a "guarantee". However, in other contexts this term has been interpreted broadly and encompasses "any arrangement under which a person directly or indirectly assures, on a conditional or unconditional basis, the payment of another's obligation". Under this broad definition any fees in respect of any credit support for the indebtedness of a U.S. corporation would be treated as U.S. source and subject to withholding tax.

In addition, the payment need not come from the U.S. obligor to be subject to being treated as U.S. source and be subject to withholding tax. For example, an "indirect payment" can include a guarantee fee paid by a non-U.S. entity (Lender) to a non-U.S. corporation (Guarantor) for the Guarantor's guarantee of indebtedness owed to the bank by a U.S. affiliate of the Guarantor if the bank recoups the fee (i.e., by charging additional interest to the U.S. company). In this case, the legislation would treat the fees received by the Guarantor from the Lender as U.S. source guarantee fees.

As noted above, treaty relief may be available to reduce or eliminate the withholding tax on the guarantee fee. The "other income" article in many U.S. income tax treaties may exempt guarantee fees from source country taxation. Guarantee providers (such as banks or surety companies) that are resident in a jurisdiction with a tax treaty with the United States should confirm the treatment of guarantee fees under the applicable treaty. Guarantors in non-treaty jurisdictions or jurisdictions where the tax treaty does not contain an "other income article" will have to contend with the additional withholding tax.

Similar to the position commonly reached on tax gross-up provisions in loan agreements, we expect U.S. obligors to require that any person receiving a guarantee fee qualify on "day-one" to receive that fee free of withholding tax.

Stephen Land and Francisco Duque, New York

Stephen Land

Francisco Duque

Balance sheet insolvency: the point of no return?

Under English law, a company is considered insolvent when it is unable to pay its debts. There are two primary tests in the Insolvency Act 1986 of an inability to pay debts – "cash flow insolvency" (s123(1)(e)) and so-called "balance sheet insolvency" (s123(2)).

The Court of Appeal's recent decision in *BNY Corporate Trustee Services Ltd v Eurosail & Ors* [2011] EWCA Civ 227 is the first judicial consideration of the test under s123(2). The judgment illustrates the difficulty posed by the "balance sheet insolvency" test but offers little clarity as to how it may apply in practice. The decision suggests that what is commonly referred to as a "balance sheet insolvency" test under s123(2) is effectively a medium and long term liquidity test to be judged on a case by case basis. If parties wish to rely on insolvency on an accounting basis, this decision suggests that they should draft carefully and not rely on s123(2).

Background

The case concerned an issue by Eurosail of five classes of notes, as part of a securitisation transaction in relation to a portfolio of UK mortgage loans. There were two priorities of payment – a priority of payment to noteholders before enforcement and a priority of payment to noteholders after enforcement. Enforcement could only take place, however, if there existed first an event of default. One class of noteholder argued that there had been an event of default because Eurosail was unable to pay its debts within the meaning of s123(2), since its latest audited balance sheet showed a net deficit of over £70m.

Section 123(2) provides that a company is deemed unable to pay its debts if it is proved 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 its contingent and prospective liabilities. The Court of Appeal held that:

> the test under s123(2) requires more than a simple mechanistic approach of looking at whether the liabilities exceed the assets and it would be extraordinary if it was satisfied every time a company's liabilities exceeded the value of its assets;

> the purpose of s123(2) is to cover situations where it is, in practical terms, clear that a company will not be able to meet its future or contingent liabilities such that it has reached "the point of no return", "the end of the road" and the "shutters should be 'put up'"; and

> on the facts, Eurosail had substantial assets (the current asset deficit was less than 17 per cent. of the assets), its liabilities were to be met over a long period and they were based on the assumption that exchange rates (used to calculate the foreign currency liabilities to noteholders and in respect of which Eurosail had lost its currency hedge with a Lehman entity) would remain constant, but in fact such

rates were volatile and there was potential for significant change. Accordingly, despite the audited balance sheet deficit, it had not been established that Eurosail had reached the point of no return and the Court found that it was not unable to pay its debts within the meaning of s123(2).

Where next for balance sheet insolvency?

The “balance sheet insolvency” test of s123(2) remains something of an enigma following the Court of Appeal’s decision, but the case provides some guidance:

> it is not a mechanical “assets-based” test, so simply looking at the audited accounts is only a start and it may be appropriate to depart from those figures and take into account other factors (e.g. legal assets/liabilities not included on the balance sheet, assumptions used, the period over which liabilities are to be met etc);

> the figures in the audited accounts are inevitably historic, normally conservative, based on accounting conventions and rarely represent the only true and fair view, so the court will have to form its own view as to whether the company has reached the “point of no return”;

> it is essentially an imprecise, fact-specific, judgment call of the court to determine whether, looking at the company’s assets and providing for its prospective and contingent liabilities, the company cannot reasonably be expected to be able to meet those liabilities; and

> consideration will be given to when any future liability has to mature, the likelihood of a contingency occurring and the size of any likely liability.

Implications

The description of s123(2) as a “balance sheet insolvency” test does not seem entirely accurate – as this decision shows, a company may be insolvent according to its balance sheet but solvent for the purposes of s123(2). The test under s123(2) has always been difficult to apply, given the difficulty of valuing contingent and prospective liabilities. There is little doubt now that s123(2) is a legal, not an accounting, test. However, as interpreted by the Court of Appeal with its focus on whether the company has reached the “point of no return”, it is difficult to see how a creditor could ever, in practice, be confident in relying on a company having fallen foul of s123(2).

In reality, s123(2) is a test looking at the company’s medium to long term liquidity focussing mainly on its future and contingent liabilities, unlike s123(1)(e) (“cash flow insolvency”) which is primarily concerned with short term liquidity and present liabilities (although liabilities arising in the near future may also be relevant). The analysis of such medium to long term liquidity may be informed by the audited balance sheet, but a degree of judgment – and therefore uncertainty - is ultimately involved.

The decision provides companies generally with comfort that the uncertainty inherent in the subjective “point of no return” test will likely deter creditors from threatening winding-up proceedings or terminating contracts on the basis of the s123(2) test, even if in reality this ground is rarely relied on. The hurdle set by the Court of Appeal decision is a high one.

Finance parties are likely to be reluctant to allege a balance sheet insolvency trigger has occurred without seeking the directions of the court. This may have time and cost implications.

It may be more difficult for liquidators and administrators to establish that a “relevant time” (premised on the existence of s123 inability to pay debts) existed in order to reverse transactions, e.g. transactions at an undervalue and preferences. If fewer transactions are challenged by liquidators and administrators, then returns to creditors could also be affected.

Not all agreements refer to s123(2) in termination triggers. The Court was clear that if an agreement refers to the statutory test then it must be construed by reference to the meaning of the statutory provision – the statute will not be construed by reference to the agreement. Accordingly, counterparties may be better to incorporate an “assets less than liabilities” event of default in agreements without referring to s123(2) – as, for example, the LMA’s leveraged Senior Multi-Currency Term and Revolving Facility Agreement.

The decision does not radically alter the meaning of balance sheet insolvency under s123(2). For example, it has always been acknowledged that what is an asset or liability for accounting purposes may not be so for the purposes of the legal test of insolvency. However, the Court of Appeal decision has added a murky layer to the test – the need to show that the company has reached the “point of no return”.

Paul Sidle, London

Paul Sidle

The Financial Markets and Insolvency Regulations (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010

Background

The Financial Markets and Insolvency Regulations (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 (the "**Amendment Regulations**") come into force on 6 April 2011. The Amendment Regulations amend the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and the Financial Collateral Arrangements (No 2) Regulations 2003 (the "**FCRs**"). This article considers the impact of the Amendment Regulations on the FCRs.

The FCRs came into force in December 2003 and were intended to harmonise and simplify the process of taking and enforcing financial collateral (for example, qualifying security financial collateral arrangements do not need to be registered under the Companies Act 2006) and to give favourable treatment to financial collateral arrangements in insolvency (for example, qualifying security financial collateral arrangements are exempt from certain provisions of English insolvency law such as those provisions of the Insolvency Act 1986 which prohibit enforcement of security interests when a company is in administration).

The Amendment Regulations:

> expand the application of the FCRs to a new type of collateral;

> exclude floating charges which do constitute security financial collateral arrangements from the operation of certain provisions of English insolvency law;

> seek to clarify some of the interpretational uncertainties in the FCRs;

> expand the right of foreclosure to all types of security financial collateral arrangements; and

> address certain conflict of law issues on cross-border arrangements.

Credit claims to qualify as financial collateral

The FCRs define "financial collateral" as cash and financial instruments. The Amendment Regulations extend this definition to include credit claims (effectively loans made by credit institutions). Unlike cash and financial instruments, however, the Amendment Regulations do not allow the collateral-taker to deal with credit claims as if it were the owner of those claims (thereby preventing the collateral-taker from being able, for example, to rehypothecate credit claims).

The inclusion of credit claims is a helpful change which may lead to an increased use of eligible loans in certain collateral arrangements. However, collateral-takers are still likely to need to consider some broader practical considerations, such as a need to due diligence the terms of the documentation evidencing the credit claims (which is often bespoke) and the potential for this type of asset to be less liquid.

Priority of floating charges under English insolvency law

Under the Insolvency Act 1986, claims of the holder of a floating charge rank behind those of preferential creditors in a receivership, administration or winding up and also rank behind the remuneration and expenses of an administrator or liquidator. As a result, the holder of an eligible floating charge, even if within the FCRs, could find that the financial collateral subject to that floating charge was not available in its entirety in or towards satisfaction of the secured claim.

The Amendment Regulations provide greater consistency in the treatment of floating charges in insolvency by excluding floating charges which constitute security financial collateral arrangements from the rules relating to ranking set out above as regards the priority of certain creditors. This aspect of the Amendment Regulations is therefore likely to be welcomed by the market, particularly in structures where clarity on cash flows in the event of administration or liquidation is critical.

Clarification of "possession"

The FCRs require that, in order for a security arrangement to fall within their scope, financial collateral must be "in the possession" or "under the control" of the collateral-taker (or a person acting on its behalf) but only offer limited guidance on the meaning of either term in this context.

Whilst the Amendment Regulations do not provide further guidance on the control test, they do offer some clarification of the possession test (but only in the context of cash and financial instruments; not credit claims) by including a non-exhaustive definition of possession. The new definition provides that a collateral-taker will (subject to restrictions on dealing rights discussed below) be in possession of the assets where they have been credited to an account in the name of the collateral-taker or a person acting on its behalf. However, doubt remains over the extent to which a custodian can be said to be acting on the collateral-taker's behalf, particularly in the context of tri-partite collateral management services where the custodian owes duties to both the collateral-taker and the collateral-provider.

The Amendment Regulations also clarify that where the collateral-taker is acting as custodian for the collateral-provider, possession will not be lost where such a collateral-taker has credited the assets to an account in the name of the collateral-provider in the collateral-taker's books.

In the recent case of *Gray & Ors v G-T-P Group Limited Re F2G Realisations Ltd* (in Liquidation) [2010] EWHC 1772 (Ch), the view was expressed that only tangible property could ever be in the collateral-taker's possession. This seemed an unduly narrow interpretation and the Amendment Regulations are helpful in the sense that they clarify that intangible property is capable of being in the possession of the collateral-taker.

As noted above, the Amendment Regulations expand the definition of financial collateral to include “credit claims”. In the context of security arrangements the Amendment Regulations clarify that allowing the collateral-provider to continue to collect the proceeds of credit claims until further notice does not prevent the assets from being in the possession or under the control of the collateral-taker.

Increased scope to effect substitutions

The FCRs provide that, in the context of security arrangements, the collateral-provider having the right to effect substitutions with “equivalent financial collateral” or to withdraw “excess financial collateral” will not prevent the assets being under the possession or control of the collateral-taker. The FCRs define “equivalent financial collateral” narrowly (akin to the definition used in The Bond Market Association/International Securities Market Association Global Master Repurchase Agreement) such that incoming collateral must, in the case of cash, be of the same amount and currency and, in the case of financial instruments, be of the same issuer, form part of the same class or issue and be of the same nominal amount, currency and description. As a result, substitutions using assets which are not effectively identical to the substituted assets (but which nevertheless comply with eligibility criteria agreed between the parties) would not comply with this requirement. This is clearly contrary to the commercial expectations in many arrangements.

The Amendment Regulations do not change the position in relation to withdrawals of excess collateral but do seek to alleviate the equivalency constraint by stating that substitutions may be effected using assets of the same or greater value (with no mention of equivalence). However, some doubt may remain over the requirement for the collateral-provider’s rights to be limited solely to substituting for assets of the same or greater value or to withdraw excess collateral on the basis that, if the collateral-provider is allowed additional rights, there could be an argument that the requisite degree of possession or control may not be met. As mentioned above, these restrictions on dealing rights are repeated in the new provisions clarifying the meaning of “possession”.

Increased scope to appropriate assets

The FCRs allow the collateral-taker to appropriate the assets (without obtaining the court’s consent) where the security over those assets is a legal or equitable mortgage and the security arrangement provides for appropriation.

The Amendment Regulations extend this right of appropriation beyond mortgages to any security interest recognised by the FCRs (such as pledges, fixed charges, liens and certain floating charges) and collateral-takers are likely to welcome this change.

Impact of foreign insolvency proceedings on cross-border arrangements

Under existing English insolvency law there is an element of uncertainty over the extent to which an English court, when giving effect to the insolvency law of another jurisdiction, would invalidate an arrangement governed by English law which is otherwise valid. Although it is thought unlikely that the English courts would, in fact, act in this way, if they did, it is possible that an arrangement falling within the FCRs could be invalidated by an order of a court made in foreign insolvency proceedings in respect of one of the parties to that arrangement.

The Amendment Regulations go some way to preventing this outcome by providing that an English court may not, when co-operating with a court exercising jurisdiction in relation to a foreign insolvency, give effect to an order of that court (or any person appointed to discharge any functions of insolvency law in that jurisdiction) if to do so would be contrary to the FCRs (subject to this not contravening certain European Community laws imposing obligations to recognise and enforce foreign judgments in certain instances).

Many financial collateral arrangements are cross-border in nature and as such the market is likely to welcome any attempt at resolving conflict of law issues.

Conclusion

The Amendment Regulations are helpful in the sense that they expand the definition of financial collateral, give more consistent treatment to the ranking of floating charges under English insolvency law, expand rights of foreclosure, address certain conflicts of law issues and offer incremental clarity on the concepts of possession and substitution. However, until the interpretation of the FCRs is considered through a meaningful body of case-law, a degree of caution is likely to remain when seeking to rely on the FCRs.

Benedict James and Andrew Forde, London

Benedict James

Andrew Forde

Changes to the Chinese regime on external security and guarantees

Introduction

It has been a long-standing policy of the State Administration of Foreign Exchange ("**SAFE**") of the People's Republic of China ("**PRC**") to restrict the ability of Chinese banks and Chinese companies to give "external" security or guarantees, namely, security or guarantees in favour of foreign entities. This policy restricted Chinese entities from incurring contingent liabilities payable in foreign currencies.

The previous SAFE rules on external security and guarantees and the more detailed implementation measures, released in 1996 and 1997 respectively (together the "**Previous Rules**"), were considered excessively restrictive and inappropriate given market developments. In addition, the Previous Rules were seen to lack a comprehensive and logical structure and often caused confusion and uncertainty. In July 2010, SAFE issued a notice which was intended to formulate a more relaxed, efficient and structured regulatory regime (the "**New Regime**"). The purpose of this article is to give a brief overview of the New Regime.

Scope of New Regime

The New Regime only regulates PRC-incorporated security providers and guarantors and branches of foreign banks located in the PRC. In addition, the New Regime does not apply to security granted by a company or bank to a foreign entity to secure its own debt. As a result, a PRC-incorporated entity is free to grant security for its own borrowing as long as the underlying external debt is approved by SAFE under a separate set of regulations. The New Regime will govern a PRC-incorporated entity granting security or guarantees to support the obligations of a third party.

Basic structure

Under the New Regime, PRC-incorporated security providers or guarantors are broadly divided into three categories: banks, non-bank financial institutions and ordinary enterprises. The external security and guarantees to be provided are divided into two categories: those provided for financing purposes, which secure or guarantee financing obligations (such as loans, issues of bonds and financial leases) and those provided for non-financing purposes, such as product quality guarantees and advance payment security deposits. Different rules will apply depending on the particular entity and purpose of the security or guarantee.

Rules applicable to banks

Financing purposes

A bank is entitled to apply to SAFE for an annual quota for external security and guarantees for financing purposes. As long as the quota is complied with, banks can freely provide security and/or guarantees without obtaining SAFE approval each time and there is no restriction on the identity of either the debtor or the creditor of the secured or guaranteed debt. This is one of the most important changes brought about by the New Regime. Under the Previous Rules, a bank could provide security and guarantees in favour of foreign creditors for third party debt of:

> a PRC-incorporated entity provided that SAFE approval was obtained; or

> a foreign entity provided that the foreign entity was partly or wholly owned by a PRC-incorporated entity and the bank complied with its quota.

The New Regime has also changed the approach to determine the amount of the quota. A bank's quota should not exceed the lower of:

> 50 per cent. of its paid up capital or working capital (as applicable); and

> its net assets in foreign currency.

Non-financing purposes

Where external security and guarantees are provided for non-financing purposes, banks can grant security and guarantees provided that either the creditor or debtor of the underlying debt is a PRC-incorporated entity or a foreign entity which is partly or wholly (directly or indirectly) owned by a PRC-incorporated entity. In these circumstances, the bank would not be required to comply with the quota requirements and would not have to obtain SAFE approval.

Rules applicable to non-bank financial institutions and ordinary enterprises

External security and guarantees provided by non-bank financial institutions or ordinary enterprises (including wholly foreign owned enterprises ("**WFOEs**")) usually require the approval of SAFE. However, a non-bank entity that frequently provides external security or guarantees and has an appropriate internal control system may also apply for a quota. Provided that it complies with its quota (and subject to the conditions described below) a non-bank entity can generally provide foreign security and guarantees without having to obtain prior approval from SAFE.

In each case, irrespective of whether a non-bank entity is subject to case-by-case SAFE approvals or has obtained a quota, the debtor of the secured or guaranteed debt has to satisfy the following conditions:

> (A) if the security provider or guarantor is a non-bank financial institution, the debtor must be a PRC-incorporated entity or a foreign entity which is partly or wholly owned by a PRC-incorporated entity; or (B) if the security provider or guarantor is an ordinary enterprise, the debtor should be an entity set up by the security provider or guarantor

at the onshore or offshore level and in each case directly or indirectly owned by that security provider or guarantor;

> the value of the debtor's net assets must be a positive figure; and

> the debtor has made a profit in at least one year in the past three years (or five years if the debtor's business focuses on long-term projects such as natural resources development), though this requirement may be waived if the debtor was established less than three years or five years ago (as applicable).

In ascertaining a non-bank financial institution's quota, similar standards apply to those used for banks. In the case of an ordinary enterprise, the ratio of its net assets to its total assets shall not be lower than 15 per cent. and its quota shall not exceed 50 per cent. of the value of its net assets.

Commercial implications

The New Regime is a welcome relaxation and clarification of the Previous Rules. The main beneficiaries are banks (including domestic PRC banks and PRC subsidiaries or branches of foreign banks) because they now have more flexibility to carry out their external guarantee/security business.

In relation to security or guarantees provided by ordinary companies, the relaxation is less significant. The New Regime does not remove the most significant obstacle to obtaining security in PRC-related international financings. It is still almost impossible for a WFOE to provide security to support any offshore financing of its offshore parent. The Previous Rules contain a provision which says that WFOEs can provide external security or guarantee "as they see fit" without needing the approval of SAFE. In practice, it is our understanding that SAFE has never given effect to the literal meaning of this provision; instead it always refused registration of external security given by a WFOE unless the relevant debtor was a direct subsidiary of that WFOE. As a result, the New Regime merely legitimises and clarifies the pre-existing arrangement, with the only relaxation that now the debtor can also be an indirect subsidiary of the security provider or guarantor.

However, the market has already started to find ways to take advantage of the new relaxation of the restrictions on the banks with a view to avoiding the still tight control over the non-bank companies. The most common approach is the so called "internal security and external loan" structure. Under this structure, the PRC affiliate of the foreign borrower applies to a PRC bank (including a PRC branch or subsidiary of a foreign bank) for the issuance of a standby letter of credit ("**SBLC**") to the foreign lender (within the PRC bank's quota under the New Regime). In return, the PRC affiliate grants to the PRC bank security over its onshore assets to secure its reimbursement obligations under the SBLC. The drawbacks of this structure are: first, a PRC bank with the sufficient quota and willing to issue the SBLC has to be found; and second, with some ambiguous wording, the New Regime appears to prohibit any proceeds of such external loan from flowing into the PRC in any form.

The New Regime was implemented relatively recently so innovative solutions used by the market in response to it, such as the “internal security & external loan” structure are still at an early stage and are largely untested before the courts. More time is needed to see the effect of these developments.

Fang Jian, Shanghai and Frank Cui Zhe, Hong Kong

Fang Jian

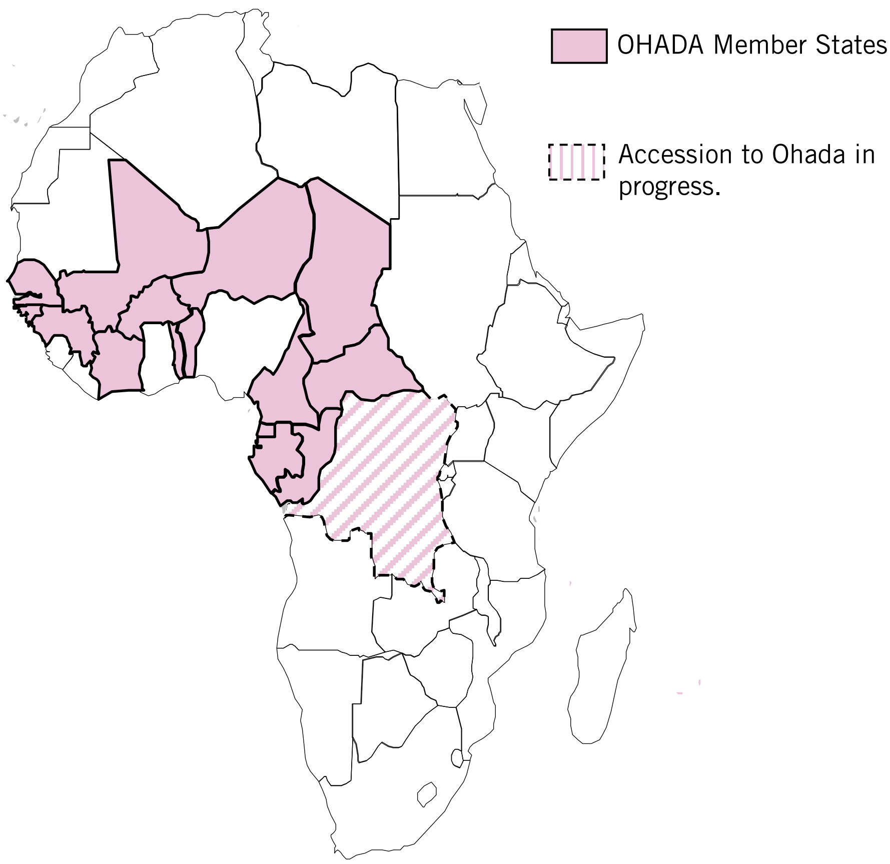
Frank Cui Zhe

Revised security regimes in Africa: the OHADA reforms

A revised security regime is about to come into force in 16 Sub-Saharan African jurisdictions. The new regime will improve the process of creating and enforcing security generally, but certain major changes are of particular relevance for finance transactions involving those jurisdictions. These include the new ability to use a security agent to hold security and the creation of new structures for creating security over assets such as receivables and bank accounts.

What is OHADA?

OHADA stands for "*Organisation pour l'harmonisation en Afrique du droit des Affaires*" (Organisation for Harmonisation of Business Law in Africa) and gathers 16 Member States of West and Central Africa (with the accession of the Democratic Republic of Congo to occur soon). Almost all of the Member States are francophone and use the "CFA Franc" currency. OHADA provides for a uniform system of business law directly applicable in its Member States through "Uniform Acts" which have been largely inspired by French law as it was in the late 1990s (when the initial Uniform Acts were adopted). These Uniform Acts concern matters such as corporate law, security, insolvency, arbitration and recognition of foreign courts' decisions.



What is the status of the reform?

The Reformed Uniform Act on Security "**R-UAS**" was published in the Official Gazette of OHADA on 15 February 2011 and is due to come into force by 20 May 2011. Security granted prior to the entry into force of the R-UAS will remain governed by the previous regime.

The R-UAS is largely inspired by the current French regime, but amended to include a number of improvements including concepts that make the rules closer to English law.

Improvements in taking and enforcing security

The R-UAS introduces a general regime governing security interests which allows for security to be granted to secure a present or future debt (which will assist in connection with taking security in respect of future/uncommitted facilities). The range of security interests available to creditors has also been extended. The type of security used will now depend on whether the secured assets are tangible or intangible. However, there is still no concept of a debenture or blanket security interest covering all or most of the assets of a company equivalent to an English floating charge. Security over each type of asset remains subject to specific creation/perfection provisions.

Enforcement procedures will improve with the introduction of the ability of the parties to a security document to agree that upon a payment default, the secured creditor may automatically (i.e. without court order) become the owner of the pledged assets subject to an independent valuation of the asset by a third party expert (save for instruments or assets traded on official markets such as listed securities or commodities, in which case the market price prevailing at the time of enforcement will be used as reference). It is not possible for the parties to agree in the security document that a payment default entitles the secured creditors to effect a direct sale to a third party rather than to become owner. The recognition of the contractual foreclosure offers an alternative to the traditional compulsory sale procedures that often result in inadequate sale prices (notably in case of auction sales).

Introduction of a "true" security agent

The R-UAS allows parties to use a security agent. The security agent must be a credit institution (whether domestic or foreign). It may constitute, register, manage and enforce security interests (including through the initiation of proceedings). The security interests held by the security agent are segregated from its own assets and are not available to its creditors generally if it becomes insolvent. The R-UAS expressly contemplates the potential for changes to the creditors for whom security is held and allows for a substitution of the agent (without any specific formality).

This mechanism will solve certain issues relating to security sharing under the previous regime where, depending on the law governing the finance documentation, separate security had to be granted to each creditor unless a "parallel debt structure" could be used.

The introduction of a security agent is therefore a major development and a point on which the R-UAS has actually gone further than French law where the recently adopted security agent/*fiducie* regime remains to be improved.

New ways to take security over receivables

The creation of a form of assignment by way of security of receivables is another major reform introduced by the R-UAS. The mechanism is similar to the French *Dailly* assignment and is intended to operate as a full transfer of title of the receivables (including continuing and future ones provided they can be sufficiently identified) to the lenders/assignee(s). In principle, notice to the debtor is not required to perfect the assignment, but if payments are to be made directly to the secured creditor, notice must be given to the underlying debtor, otherwise payments may legitimately be made to the assignor. The assignment will cover receivables identified on an assignment form (*bordereau*) delivered to the lender assignee(s). As with the French mechanism, the transfer of title is effective on the date set out on the assignment.

The assignment of receivables is available only to secure indebtedness provided under a credit facility by "entities lending funds or performing banking operations in their ordinary course of business". One notable point is that the R-UAS has overcome one of the inefficiencies of the *Dailly* assignment which is only available to licensed institutions. However, as for the French *Dailly* assignment (and on the basis that such security must be granted to secure a credit transaction) the R-UAS would not permit that the assignment be granted to secure bonds, swaps or other derivative transactions.

Cash collateral, pledges over bank accounts

A "fiduciary pledge over cash" has also been created. Under this form of security interest the secured sums are transferred to the secured creditor and deposited in an escrow account opened in its name. As with the assignment above, the intended effect is that upon enforcement the secured creditor would be able to foreclose over the collateral up to the amount of the secured debt. This mechanism is specific to OHADA law (although French case law has conferred a similar effect to pledges over cash).

Although bank accounts could be secured in practice through the pledge of receivables mechanism, a specific pledge regime has now been introduced for taking security over a bank account. The pledge would be binding on the account holder as from its notification to the account bank. The pledge would cover the sums standing to the credit of the account on the date of enforcement, subject to clearing pending transactions (whether credits or debits).

Outlook

The R-UAS is undoubtedly a significant step that demonstrates the willingness of the OHADA Member States to adopt a more creditor-friendly security regime.

In order for the new regime introduced by the R-UAS to be fully successful, certain further steps are needed. The role of the Registry of Commerce, which will be responsible for security registrations will be key as is the need to ensure that the rights of creditors created by the R-UAS are not weakened in the context of insolvency proceedings. This is a point where case law and the (announced) reform of the Uniform Act on insolvency law will play an important role.

It is worth noting that since the R-UAS largely aligns the OHADA security regime with French law, French lawyers will be able to use their experience of French financings when advising on those in OHADA Member States.

Bertrand Andriani and Aymeric Voisin, Paris

Bertrand Andriani

Aymeric Voisin

When do you have security over "substantially the whole" of a company's property?

One of the conditions to the appointment of an administrator out-of-court by a holder of a qualifying floating charge ("**QFC**") under the Insolvency Act 1986 (the "**IA 1986**") is that the security extends to "*substantially the whole*" of the debtor's assets (paragraph 14(3) of Schedule B1 of the IA 1986). Additionally, a receiver whose appointment is over the whole or "*substantially the whole*" of a company's property will be an administrative receiver (section 29(2) of the IA 1986) preventing the appointment of an administrator if one of the exemptions to the prohibition of appointment of administrative receivers applies or the charge was executed before 15 September 2003. However, the phrase has received little, if any, judicial interpretation under English law.

Whether or not a secured creditor had security over "*the whole or substantially the whole*" of a company's property was considered recently by the Victorian Supreme Court in *Re Australian Property Custodian Holdings Limited (admins apptd) (recs & mgers apptd)* [2010] VSC 492. While non-binding, the Australian decision would likely be of persuasive value to an English court faced with the same phrase in an English law context.

The decision

Australian Property Custodian Holdings Limited (the "**Company**") granted a charge to Daytree Pty Ltd ("**Daytree**") over all of its assets except for certain trust property and the sum of AUS$5m which was held on deposit at the National Australia Bank ("**NAB**") as a condition for the Company's Financial Services Licence. Daytree subsequently appointed administrators to the Company. However, the appointment was challenged by NAB on the grounds that Daytree did not have a charge over "*the whole or substantially the whole*" of the Company's property for the purposes of section 436C of the Corporations Act 2001 ("**section 436C**") so as to entitle it to appoint an administrator.

The court referred to the total value of the assets of the Company according to its balance sheet dated 4 months prior to the purported appointment. This showed assets of AUS$15,751,942. Daytree had security over $10,751,942 or 68 per cent. of the Company's property once the AUS$5m deposit was excluded.

The court held that the exclusion of the substantial bank deposit from the charge meant that the charge did not extend to "*substantially the whole*" of the Company's property. In the court's view, "*substantially the whole*" referred to almost all and 68 per cent. of the assets was not sufficient. Daytree's purported appointment of the administrators was therefore invalid.

What clarification does this decision offer?

Given the similarities between section 436C and the English tests under paragraph 14(3) of Schedule B1 and section 29(2) of the IA 1986, the

Australian judgment provides useful guidance and clarification on how the phrase “*substantially the whole*” would likely be interpreted.

The Australian court looked at the value of the assets according to the most recent (June 2010) balance sheet of the Company which was available before the purported appointment (in October 2010) to see whether the charge was over substantially the whole of the Company’s property. No reference was made to the value of the Company’s assets as at the date of creation of the charge (in July 2008). The court recognised that all the balance sheet showed was the value at a particular time and that the property of the Company could fluctuate. However, on the facts, the exclusion of the AUS$5m deposit was considered definitive as it represented a substantial asset of the Company.

The decision indicates that value of the assets as at the date of creation of the charge is not relevant in determining whether the “*substantially the whole*” test is satisfied. It is the value of the assets as at the date of appointment which will determine whether the test can be met. In this case, that value was assessed by reference to a balance sheet dated some 4 months before the appointment, but given the exclusion of such a substantial asset this was not an issue and was considered sufficient.

By referring to the Company’s balance sheet, the Australian decision suggests that the appropriate financial value of the assets is to be assessed by the chargor and not by the secured creditor. It is also clear that the use of the chargor’s most recent financial statements, management accounts or audited accounts would appear to be the most sensible way to assess value as at the date of appointment.

Implications for secured creditors

When enforcing security, whether a secured creditor is a QFC holder or can appoint an administrative receiver will have an impact on the options and strategies available. For example, only a creditor who is a QFC holder may appoint an administrator out-of-court with no need for the creditor to show that the company is or is likely to become unable to pay its debts. A QFC holder is also entitled to prior notice of any appointment by the company or its directors (or any prior QFC holder). In the limited circumstances where an administrative receiver may be appointed, that appointment would prevent any subsequent appointment of an administrator.

If the time came to enforce, a creditor from whose security potentially valuable assets are excluded may be at risk of fluctuations in the value of that property since the date of creation. For example, if certain land excluded from the charge at the date of creation subsequently receives planning permission, its value is likely to increase. As a result, the secured creditor may no longer have adequate security coverage to satisfy the “*substantially the whole*” test at the time of appointment. Falls in the value of the charged assets could have a similar effect.

The decision highlights the dangers of excluding assets from the scope of the security package, for example because they are already subject to security in favour of another creditor. In such a situation it would be better to take second ranking security over the asset rather than exclude it from the security. When taking security over contractual rights a restriction on transfer or creation of security in the underlying contract may prevent the valid creation of security. Where such contractual assets are material, consent should be sought from the counterparty to the contract so that security over those assets can be given.

The Australian decision while non-binding nevertheless offers some assistance, in the absence of English authority, as to what an English court would likely consider when determining the extent of the security over a chargor's property. It also illustrates the dangers of assets being excluded from the scope of a creditor's security.

Paul Sidle, London

Paul Sidle

Subordination and insolvency proceedings in France

Subordination of one class of creditors to another class of creditors may take various forms: (i) structural subordination resulting from the location of the debt within the debtor group; (ii) contractual subordination as frequently used in syndicated loans and bond issues which are structured in several debt tranches, pursuant to subordination agreements or intercreditor agreements; and (iii) subordination as a result of general law.

The treatment of the two last types of subordination in the context of French insolvency proceedings, particularly safeguard (*procédure de sauvegarde*) or judicial reorganisation (*redressement judiciaire*) proceedings, has recently been clarified by (i) the reform of the Business Safeguard Act (*loi de sauvegarde des entreprises*) made pursuant to the Banking and Financial Act dated 22 October 2010 and (ii) the Thomson case.

Treatment of subordination agreements in safeguard proceedings or judicial reorganisation: the new reform of the Business Safeguard Act

Although the validity of subordination as a concept does not raise particular issues under French law, the enforceability of subordination clauses or agreements vis-à-vis the judicial administrator in French insolvency proceedings affecting the borrower has been unclear.

Unlike U.S. bankruptcy law, in France creditors' committees established for the purpose of voting on the draft safeguard or reorganisation plans of large companies (being those with more than 150 employees and/or a turnover of more than 20 million Euro) are not established based on the ranking of the creditors' claims but rather on the nature of the claims and, to a lesser extent, the type of creditor. Creditors whose claims arise pursuant to a credit operation (such as a loan or derivative transaction) are grouped together in the credit institutions' committee (whether or not the creditors are in fact credit institutions). Bondholders are grouped together in a separate voting group. These creditors' committees and the bondholders' meeting bring together creditors with different positions: unsecured or secured, privileged or subordinated.

An exception to the principle of equality amongst creditors has been introduced by the Business Safeguard Act of 26 July 2005 as amended by the Ordinance (*ordonnance*) of 18 December 2008, which allows a "differentiated treatment" between creditors "if the differences in situation so justify".

The recent reform of the Business Safeguard Act of 22 October 2010 has supplemented this rule by providing that the draft plan proposed to the creditors "takes into account the subordination agreements entered into by creditors before the opening of the procedure".

These provisions have a practical impact on the obligation of the court to ensure, before approving any plan accepted by each committee and, as applicable, by the bondholders' meeting, that the "interests of all creditors are sufficiently protected". These interests should now be assessed by the court with regard to the economic interests of creditors and the contractual ranking of their claims.

However, the law does not provide for subordination to be taken into consideration in the exercise of voting rights by the creditors. Therefore, a vote by a two thirds majority (by amount of claims held by voting member) of the credit institutions' committee is required to adopt the plan without distinction between senior and junior claims. In addition, the approval of the bondholders' meeting is always required for the adoption of the plan regardless of whether or not the bondholders are subordinated. In France, mezzanine debt has typically been structured in the form of bonds, thus allowing the mezzanine creditors "hold out rights" in a safeguard.

Finally, an omission is soon to be dealt with in a bill currently in its second reading in the Senate. The law requires subordination agreements entered into by creditors before the opening of insolvency proceedings to be taken into account by the credit institutions committee for the purposes of the draft safeguard plan. There is no requirement to take such agreements into account with respect to the bondholders' meeting, but the bill would change that.

The question of the enforceability of subordination clauses or agreements in case of liquidation proceedings has however not yet been addressed. In the absence of clear case law on this issue, it is not certain whether a judicial liquidator is required to follow contractual rankings for the allocation of the proceeds of assets among creditors as a result of the liquidation. However, this change to the law gives support to the conclusion that it would be required to do so.

Treatment of holders of super-subordinated bonds with unlimited duration in safeguard proceedings: the Thomson case

The Thomson case, another example following the Autodis case of a "pre-pack" plan under French law, has created a debate concerning the treatment of claims of holders of super-subordinated bonds with unlimited duration ("**TSSDI**") in the computation of voting rights in the bondholders' meeting in case of safeguard proceedings.

Technicolor (formerly Thomson) had issued TSSDI for a nominal value of 500 million Euro. TSSDI are securities whose nominal value is repaid after all the other creditors have been paid and just before the repayment of shareholders, and only in case of liquidation (judicial or voluntary) or transfer of the business in the context of a reorganisation procedure (except for certain early prepayment events).

Holders of TSSDI were authorised to vote on the draft safeguard plan, not based on the nominal value of the TSSDI, but based on an estimation of their claims for future interest, on the ground that the TSSDI have been issued for unlimited duration and the draft plan does not affect their nominal value. The safeguard plan was sanctioned by a decision of the Commercial court of Nanterre of 17 February 2010, rejecting the claim by several holders of TSSDI that they had been deprived of their voting rights.

In a decision on 18 December 2010, the Court of appeal of Versailles recognised that holders of TSSDI should be allowed to vote in the bondholders' meeting based on the nominal value of the TSSDI. However, the Court of appeal confirmed the decision of the Commercial court of Nanterre on the grounds that there was no practical impact since even if the TSSDI holders' votes had been included for their nominal value, the outcome of the vote would not have been altered.

To close off this debate, the recent reform of the Business Safeguard Act of October 2010 provides that the creditors "for whom the draft plan does not modify the conditions of payment or provides for a total payment in cash on the adoption of the plan or on the admission of claims" do not participate in the vote on the draft plan. The bill currently before the French Senate extends this provision to the vote of the bondholders' meeting also.

The new provisions introduced by the reform of October 2010 shall apply to safeguard proceedings and judicial reorganisations to be commenced from 1 March 2011 onwards.

The bill introducing the changes affecting bondholders' meetings is expected to be adopted before summer 2011.

Nathalie Hobbs, Aymar de Mauléon and Caroline Schumacher, Paris

Nathalie Hobbs

Aymar de Mauléon

Caroline Schumacher

Linklaters

Amsterdam
Martijn Koopal
Onno Bakker
Telephone: (31-20) 799 6200
Facsimile: (31-20) 799 6300

Bangkok
Wilailuk Okanurak
Pichitphon Eammongkolchai
Telephone: (66-2) 305 8000
Facsimile: (66-2) 305 8010

Brussels
Jacques Richelle
David Ballegeer
Telephone: (32-2) 501 9411
Facsimile: (32-2) 501 9494

Dubai
Sarosh Mewawalla
James Martin
Telephone: (97-14) 369 5800
Facsimile: (97-14) 369 5801

Frankfurt
Eva Reudelhuber
Carl-Peter Feick
Michal Hlásek
Telephone: (49-69) 7 10 030
Facsimile: (49-69) 7 10 03333

Hong Kong
Trevor Clark
David Irvine
Stuart Salt
Telephone: (852) 2842 4888
Facsimile: (852) 2810 8133

Lisbon
Pedro Siza Vieira
Telephone: (351) 21 864 00 00
Facsimile: (351) 21 864 00 01

London
Robert Elliott
John Tucker
Jeremy Stokeld
Telephone: (44-20) 7456 2000
Facsimile: (44-20) 7456 2222

Luxembourg
Janine Biver
Patrick Geortay
Telephone: (352) 26 08 1
Facsimile: (352) 26 08 88 88

Madrid
Pedro De Rojas
Ben Crosse
Conrado Tenaglia
Telephone: (34) 91 399 60 00
Facsimile: (34) 91 399 60 01

Milan
Andrea Arosio
Davide Mencacci
Telephone: (39) 02 88 3935 1
Facsimile: (39) 02 88 3935 201

Moscow
Michael Bott
Dmitry Suschev
John Stansfield
Telephone: (7-495) 7979 797
Facsimile: (7-495) 7979 798

New York
Michael Bassett
Martin Flics
Jeff Norton
Telephone: (1-212) 903 9000
Facsimile: (1-212) 903 9100

Paris
Bertrand Andriani
Nathalie Hobbs
Olivier Jauffret
Telephone: (33-1) 56 43 56 43
Facsimile: (33-1) 43 59 41 96

Rome
Luigi Sensi
Telephone: (39-06) 3671 2239
Facsimile: (39-06) 3671 2538

São Paulo
Eduardo Lima
Telephone: (55-11) 3024 6300
Facsimile: (55-11) 3024 6400

Shanghai
Simon Poh
Telephone: (86-21) 2891 1888
Facsimile: (86-21) 2891 1818

Singapore
Philip Badge
Chee Wai Kok
Telephone: (65) 6890 7300
Facsimile: (65) 6890 7308

Stockholm
Per Nyberg
Telephone: (46-8) 665 66 00
Facsimile: (46-8) 667 68 83

Tokyo
Christopher Bradley
Telephone: (81-3) 6212 1200
Facsimile: (81-3) 6212 1444

Warsaw
Jaroslaw Miller
Telephone: (48-22) 526 50 00
Facsimile: (48-22) 526 50 60

Contacts

For further information please contact:

Jeremy Stokeld
Partner

(+44) 20 7456 4434

jeremy.stokeld@linklaters.com

Andrew Stanfield
Managing PSL

(+44) 20 7456 4935

andrew.stanfield@linklaters.com

One Silk Street

London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com