CURRENT ASPECTS OF UNSECURED LENDING SUBORDINATION

QUESTIONS AND ANSWERS

Question - John Cadell:

I guess, Don, what you were saying is that you would not preclude considering subordinated debt as capital for most ratios?

Response - Don Argus:

No, we certainly would not preclude it but I think in the case of the Bond Brewing side of it I suppose we have to look at the deal as an on-going venture and whether we treat it as capital or whether we treat it as debt is purely a subjective judgment. In that instance, the argument was being put in the negotiations that because we had junior subordinated debt in there, that could be treated as capital. Now, whether the lenders agreed to that or not that was certainly a debatable point around the table.

Question - Paul Rogerson (Gadens, Sydney):

I have one point to make in relation to something Mr Cashmere said about the public policy question in Australia. I thought the public policy question in Australia had cleared itself up somewhat with the recent decision of the single judge of the Supreme Court of Victoria where his Honour distinguished the British Eagle case and held that a subordination agreement as between the parties to it would be upheld in a liquidation and the liquidator could pay out in accordance with the terms of the subordination agreement.

The next point I wanted to make is that in relation to the use of the subordinated trust I was wondering what the consequences of that would be for stamp duty purposes in New South Wales. I thought that could be somewhat horrific in certain circumstances.

Thirdly, in relation to the point that Mr Loxton made about the use of what would be a "Quistclose" trust where the subordinated creditor agreed to hold moneys on trust for the senior creditor. Is he suggesting that such a trust would be a registrable charge and if so why?

Response - Maurice Cashmere:

I suppose the only comment I really need to make in relation to the Victorian single judge case is that that was a decision of a single judge in Victoria and the British Eagle case was the House of Lords. And on a matter of such importance one would tend to favour a considered judgment of the House of Lords rather than a single first instance judge.

Response - Diccon Loxton:

That reminds me that the Eureka Stockade was in Victoria. Whatever the single judge in Victoria has done I think that the major problem is, as I say, in the winding up of the junior creditor. In the borrower's winding up you can work out all sorts of ingenious solutions. More problems occur when you look at the winding up of the junior creditor. Now I think the question I was asked was - if you had a subordination trust of what was suggested would be the Quistclose variety, is it a registrable charge, and if so, why?

I guess the question as to whether it is a registrable charge or not is yes, or no, depending on what it is you are purporting to charge. If you direct your charge in such a way that it can be considered to be a charge of the underlying debt owed by the borrower to the junior creditor; if in some way that charge or that trust gives some type of rights directly in what you might call the "tree" in the arrangement of that debt; then quite clearly, if that debt constitutes a book debt, you would have a registrable charge and the ensuing problems.

If however you try and analyse the sort of property you have and not go for the "tree", not go for the rights to the debt but go in some way to the "fruits", and say that the trust establishes in respect of cash received by the junior creditor in respect of that debt or dividends or cash received in respect of that debt on the winding up of the junior creditor, then you would not have a registrable charge.

There is a grey area here and that is the question as to what happens if you try and have the trust over the rights of the junior creditor in the winding up of the borrower. The question is, is the right to have dividends paid out in a liquidation a book debt? There are English cases which would suggest that it is not. It is merely a right against a statutory officer to have that statutory officer apply assets in certain ways. But again you have to be very careful because it seems to me that the arguments which would distinguish between book debts and dividends are really another version of the "fruit" and the "tree" argument. The Shepherds case argument, if you like. And you would have to be very careful that you were only talking about the actual dividend you received and not the underlying debt that gave right to those dividends.

I suppose all of that is based on the assumption that it is a charge. I think it is quite clear that trust arrangements can constitute a charge. The case of Re Bond Worth was one such example. If you look at the definitions of charge that are quoted in the various judgments in the Lloyds Bank v. Swiss Bank case it is quite clear that if you segregate property and give someone a proprietary interest in that property towards paying debts then in those circumstances that will constitute a charge.

The only sort of exception to that is the type of arrangement with Peter Gibson J. identified in the Carreras Rothmans case (which Maurice referred to before) which was a different kettle of fish. That was a case when it was quite clear that the money was paid into a trust account for the sole purpose of discharging identifiable debts. Under no circumstances could you have said that there was any type of equity of redemption in that arrangement. Further, one of the arguments that Gibson raises as I understand it, although he is fairly woolly on the subject, was that the amounts paid into that trust account were not assets of the company to begin with, that latter argument would not be available here. At the first argument, in this case you have got a trust over all moneys which are paid up by the borrower to the junior creditor. I think anybody, any court looking at the substance of that transaction, would look at the situation where the moneys which were paid up by the borrower to the junior creditor exceeded the amount that the junior creditor owed to the senior creditor, and would say, "well, where would the money go after that?". And the answer would be that, of course, it would go back to the junior creditor. I think it would be highly likely that a court in those circumstances would find that an equity of redemption existed and that kind of arrangement was a security arrangement of the normal charge type that we have all grown to know and love, but try to wriggle away from by negative pledge lending.

Question - Bruce Johnston (Baker & McKenzie):

Just a comment for Don Argus on the question of whether it is debt or equity. I am sure he would always like to argue when he is filling in the bank's tax return that it is really debt and that he wants a tax deduction for the interest being paid. I am just a little concerned that if continual arguments are made that subordinated debt is a form of equity that the tax office may take up that argument and not allow a deduction.

Response - Don Argus:

I assume that you are referring to the bank's balance sheet in the first question. The context in which I was promoting the subordinated debt and is challenged by the regulators is that of capital adequacy rules that the banks come under. I believe that the taxation issue is a separate issue and I am sure that the banks still get that benefit of the tax deduction. But pure capital adequacy for ratio purposes is the critical issue as far

as what is treated as capital and what is treated as subordinated debt in a bank's balance sheet.

Question - John Sullivan (Sydney):

This actually is not a new question, it was raised earlier. Stamp duty on subordination arrangements. The common practice I think is to stamp them in New South Wales as agreements under hand but I think on Diccon's arguments they should be stamped as either declarations of trust or charges, each of which carry quite different rates of duty. I don't know what the answer is but am interested in your comments.

Response - Diccon Loxton:

If you have property in New South Wales the good news would be that it would be a charge and not a declaration of trust because duty is obviously less. If you say that there is a trust and not a charge then clearly there is a declaration of trust and the real question is do you have any nexus with New South Wales? Do you have any property in New South Wales? And that is where arguments as to whether or not you are dealing with New South Wales stamp duty would lie. Arrangements could be made to take out that nexus but I don't have long enough to discuss it.