HOW EFFECTIVE IS YOUR SECURITY — THE IMPACT OF RECENT CASES

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LINTER GROUP

As John as indicated, this session splits into two halves. Unfortunately the first half will be somewhat academic and even esoteric. Indeed the response of most people with whom I have discussed some of the relevant issues is best exemplified by David Bruce's reaction when he heard that part of my paper deals with the differences between mere equities and equitable interests. Really? How interesting - I come across those all the time. However I make no apology for this. I believe that the judgment in **Linter** is wrong and the only way I can justify this is to return to first principles. At the end of the day though, my message is simple. I do not expect anyone to leave today remembering (or caring to remember) the differences between an equity and an equitable interest or which principle dictates the priority between competing interests. Rather, the message is - beware the constructive trust. **Linter** is a classic example of the difficulties and uncertainty that arises when constructive trusts, which depend to a great extent on judicial discretion and the court's view of what is fair, are applied in a commercial context.

If society is now demanding that business be regulated by the concept of fairness, which, to some extent, has been alien to dealings in a capitalist economy, then this must be clearly and unambiguously effected, rather than left to be developed by the courts in an ad hoc fashion.

The facts in **Linter** are complicated and the issues that arise are numerous, complex and in many instances difficult. I intend to focus on two aspects of the decision only - the Citibank tracing claim and the priority dispute between Linter and CIBC. In the limited time available, I will only be able to highlight the issues that arise. I have chosen these aspects for two reasons:

First, I believe that, with respect, the judge's determinations are wrong in relation to some of the relevant issues.

Secondly, the ramifications of this for lenders and their advisers are significant and, to some extent, alarming.

The facts relating to the Citibank tracing claim are complex, and in terms of comprehending the issue, unnecessarily complicated. For our purposes, they can be summarised as follows:

Linter received into its London bank account an amount in sterling in respect of which Citibank claimed it held an equitable interest.

As a means of repatriating these funds to Australia, Linter terminated various swap and forward rate agreements, utilising the sterling to make the termination payments required of it under these agreements, and receiving in Australia certain A$ payments from the counterparties, in satisfaction of their respective termination obligations.

A very typical series of treasury transactions.

Citibank claimed it was able to trace the proceeds received by Linter in Australia.

Mr Justice Southwell held that tracing failed because of the use of the moneys in terminating the currency transactions, accepting the argument that the money received in Australia by Linter represented the payment by the counterparties of their debt obligations to Linter and therefore that the fund had been extinguished. I do not agree.

While I accept the general principle on which the judge relied, namely that tracing ceases where a fund can be shown to have been exhausted, I question its applicability to this situation. I do not believe that the fund had been exhausted by the termination of the currency transactions. The judge correctly determined that where the funds being traced are paid to satisfy a debt, the funds cannot be traced into the hands of the creditor, if the creditor does not know that the funds are being misapplied. That is the reason that the termination payments could not be traced into the hands of the counterparties. However I believe that the judge took too narrow a view of what constituted the fund, and, in so doing, disregarded the other side of the transaction. I believe that, as a result of the termination of the currency transactions, an asset arose in Linter's hands, the A$ received by Linter from the counterparties, which should have remained subject to Citibank's tracing claim.

Support for this view can be found in the, as yet, unreported decision of Mr Justice Hobhouse in **Westdeutsche Landesbank and Islington**, which is one of the Hammersmith aftermath cases. This case concerned moneys taken from an account and placed on the money market, with different amounts later being deposited back to the account, the judge finding that the right to trace remained extant in such circumstances. To my mind the principles applied by the judge in **Westdeutsche** are equally applicable to the swap termination payments. I should note that **Westdeutsche** is subject to appeal. That appeal will hopefully resolve the issue.

The facts in relation to the CIBC and Linter priority dispute are also complex. A simplified version is:

> CIBC lent funds to Arnsberg to enable it to complete the takeover of Brick and Pipe. Arnsberg had already acquired a holding in Brick and Pipe, utilising funds lent to it by Linter and other Goldberg companies.
>
> Arnsberg granted what was purported to be a first equitable mortgage over the Brick and Pipe shares in favour of CIBC.
>
> Arnsberg was a $2 company which was ostensibly in a different group from Linter, although both groups were ultimately owned and controlled by Abe Goldberg and his family interests.
>
> No security was granted or loan documentation produced in respect of the Linter advance. No resolutions were passed or meetings held by the directors of Linter approving the transaction.
>
> Arnsberg sold the Brick and Pipe shares realising proceeds, net of certain preferential payments, of approximately $250,000,000.
>
> Each of Linter and CIBC claimed entitlement to and priority in these proceeds.

The arguments put forward by the liquidator of Linter can be summarised as follows:

> The directors of Linter breached their fiduciary duties to Linter in making the unsecured loan to Arnsberg. The basis of this claim was that there was a total lack of benefit to Linter in advancing the funds.
>
> Arnsberg received the money with notice of the breach and accordingly held the shares as trustee for Linter.

As a result Linter had an equitable interest in the Brick and Pipe shares which it could trace through to the proceeds of sale.

This equitable interest took priority over the equitable interest of CIBC, as CIBC took its interest with constructive notice of the breach of directors' duties.

The judge found that a breach of directors' duties had occurred, rejecting, in particular, the argument that, in considering the question of benefit to Linter, the directors could consider whether any benefit accrued to the group as a whole from entering into the transaction. Unfortunately, I do not have time to deal in detail with the judge's finding in this regard. I understand that Stephen may also have some comments in this regard. Suffice it to say, that, while ultimately the finding that a breach had occurred is supportable, there are a number of factors on which the judge placed no weight which, to my mind, militate against the strong stance he adopted. These factors may not have affected the finding that a breach had occurred. However, I believe that they are important to the consideration of whether CIBC, as a 'stranger' (albeit friendly), had constructive notice of the breach, in that it was put on enquiry.

One point that I do wish to draw to your attention, however, is the fact that the stance taken by the judge on group benefit is contrary to that taken by the High Court of Australia in the recent **Equiticorp Financial Services and BNZ** decision. In that case the court found that, in considering whether a breach of directors' duties had occurred, the directors can take account of benefit to the group as a whole, provided that the company of which they are directors receives, or expects to receive, some derivative benefit from that group benefit.

It will perhaps prove beneficial, if we pause here and run briefly over the position reached this far.

Linter made an unsecured loan to Arnsberg.

CIBC made a loan to Arnsberg and took security over the Brick and Pipe shares.

The loan by Linter represented a breach of duties on the part of the directors. Arnsberg received the loan proceeds with notice of the breach.

Arnsberg sold the Brick and Pipe shares realising net proceeds of $250,000,000.

Each of Linter and CIBC claimed entitlement to and priority in these proceeds. Linter, by virtue of an equitable interest arising in the Brick and Pipe shares (and therefore sale proceeds) at the time and as a result of the breach of directors' duties, CIBC, by virtue of its security interest in the shares and therefore the sale proceeds.

The first issue to be considered is the nature of Linter's interest, if any, consequent upon the breach of director's duties. In this regard, the judge held that Linter had an equitable interest in the Brick and Pipe shares, due to the fact that the directors of Arnsberg knew of the breach and accordingly Arnsberg received the funds with notice of that breach and was a constructive trustee for Linter.

In reaching this view the judge rejected the arguments put forward by CIBC, that Linter's interest was a mere equity until such time as the loan contract was avoided. To the contrary, he found that an equitable interest arose at the time the directors were required to restore the property, presumably at the time the funds were advanced to Arnsberg. With respect, I believe that the judge's analysis in this regard is wrong.

In reaching his decision, the judge appears to have believed that, in relation to a voidable contract, the imposition of a constructive trust is required to found the proprietary interest of the party that has the election to avoid and that, as a result, the interest that arises is an equitable interest rather than a mere equity. This is incorrect.

I believe that the following is the correct analysis:

A company had entered into a loan contract. In procuring the company to enter into that contract, the directors had breached their fiduciary duties to the company. On the basis of accepted principles, that breach of duty can be ratified by the shareholders of the company and, until such time as the company elects either to ratify the contract or to avoid it, the contract is merely voidable and not void *ab initio*. Furthermore, until such time as the company elects to avoid the contract it has a mere equity only in the property subject to that contract. Once the contract is avoided however the company has an equitable interest. The distinction between a mere equity and an equitable interest is fundamental to this discussion, given that the determination of the nature of the interest dictates the priority principles that apply. It is worth therefore briefly reviewing this difference, given that many practitioners are either unaware that a difference does exist, or alternatively exactly what the nature of that difference is. An equitable interest is a proprietary or real right in property, a right *in rem*. A mere equity, however, is not a real right in property, but a personal right, a right *in personam*, given to a person who has conferred an interest or right on another, to set aside or qualify the transaction by which that interest or right was conferred. Typical examples of equities are the right to rescind a contract for fraud, misrepresentation or undue influence; to have a transfer set aside for mutual mistake or breach of fiduciary duty; to obtain rectification of an instrument which does not truly record the agreement reached between the parties; and to set-off one monetary obligation against another.

The issue centres upon the nature of the interest of a party to a voidable contract, both prior to and after the avoidance of that contract. The imposition of a constructive trust to found an equitable interest in the subject matter of the contract is not required. Rather the issue is purely one of tracing. Once a party to a voidable contract has avoided that contract, that party is entitled to obtain recovery of its property and therefore is entitled to trace its property in equity. However, as I have said, until such time as the election to avoid occurs, that party has a mere equity only and not an equitable interest.

The ability of the party avoiding the contract to trace its property falls to be determined in accordance with established equitable principles relating to notice, in respect of a third party that acquires a competing interest prior to avoidance, or timing (coupled with estoppel) in relation to a third party that acquires an interest after avoidance. The burgeoning body of constructive trust jurisprudence is and should remain irrelevant to this determination, except to the extent only that the imposition of a constructive trust may be required to ensure that the party to the avoided contract is able to recover its property from a third party that receives the property with notice of its prior interest.

Given the significance of this aspect of the judgment, in that, having gone off the rails, as it were, in respect of this preliminary, but fundamental issue, the judge found himself in difficulty in subsequently attempting to apply the established priority principles, I believe that it is worth running through this analysis once again.

Until the company elects to avoid the loan contract, the contract is merely voidable and not void *ab initio*.

Until such time as the company elects to avoid the contract it has a mere equity only in the property subject to that contract.

Once the contract is avoided the company has an equitable interest.

Once the company has avoided the contract, the company is entitled to obtain recovery of its property and is therefore entitled to trace its property in equity. The issue is therefore one of tracing not constructive trust. The imposition of a constructive trust is not required to found an equitable interest in the subject matter of the contract.

To some extent (although this is not openly expressed in the judgment), the judge's finding is, I believe, reflective of the growing body of precedent to the effect that the role of the court in such circumstances is to determine which of the parties has the 'better equity'. However, this new approach (pursuant to which the court endeavours to determine the fairest result between the parties) has grown out of situations involving the imposition of a remedial, rather than institutionary, constructive trust, that is where a trust is required to found a proprietary interest when none might otherwise exist. Its application, as **Linter** evidences, to a situation involving a voidable contract leads to uncertainty, particularly when the court turns to consider priority issues relating to competing claims, in that, because of the failure to return to first principles at inception, the established principles relating to the determination of priority between competing equitable interests, or between equities and equitable interests, must be disregarded or, rather, an amalgam of such principles requires to be applied. The result is confusion and uncertainty, which is unacceptable in relation to commercial dealings.

The next issue relates to the priority position in respect of the competing claims of Linter and CIBC.

Having found that Linter held an equitable interest, which arose at the time of the breach by the directors of their duties, the judge applied the bona fide purchaser for value test in determining priority between Linter and CIBC. In considering CIBC's position, the judge found that CIBC had constructive notice of the breach of directors' duties and therefore that Linter's interest should take priority. With respect, this was not the right test to apply in respect of competing equitable interests. Rather, the first in time maxim should have been applied. It was however the right test to apply if Linter had a mere equity only. If Linter held a mere equity, CIBC would, by virtue of holding an equitable interest, have had priority over Linter's equity unless Linter could establish that CIBC was not a bona fide purchaser for value without notice. Given this, the judge's discussion of whether CIBC was a bona fide purchaser remains germane and represents an important part of the decision. This will be considered shortly.

Where the issue is one of competing equitable interests, then the first in time maxim should apply. This provides that where the merits are equal, the first in time prevails. However where, for instance, a holder of the earlier equitable interest by conduct leads the later interest holder to acquire its interest on the supposition that the earlier did not exist, then the maxim is displaced and the later interest will take priority.

Counsel for CIBC argued just that, namely Linter, as the holder of the earlier equitable interest by conduct led CIBC to acquire its interest on the supposition that Linter's interest did not exist. This was also rejected by the judge, who stated that no representation or conduct of Linter was proved to have induced CIBC to enter into the agreement, despite the fact that warranties were given by Linter that were relied upon by CIBC.

Given that the directors of Linter were also the directors of its holding companies and the fact that a breach of directors' duties can be ratified by the company's shareholders, this aspect of the decision appears questionable. More importantly, in my view, the difficulties that arise as a result of the adoption of the 'better equity' approach are further exemplified in this aspect of the judgment. In considering this issue, the judge appeared to accept that the estoppel argument carried weight, indeed it was in his words 'initially attractive'. However on the 'unusual' facts it was dismissed. In fact, if CIBC was not a bona fide purchaser for value then the issue of estoppel is irrelevant. I believe that the judge's deliberations reveal that, albeit subconsciously, he determined the issue on the basis that, to his mind, Linter had the better equity. The problem with this approach, however, is that other principles and rules of law arise (such as the established principles relating to priority) which somehow have to be distinguished or dismissed, leaving the state of law in the area uncertain and confused.

As I have said, the judge determined that CIBC did not discharge the onus it bore in proving that its equitable interest was acquired without notice of Linter's earlier interest. In so finding the judge determined that constructive notice is sufficient for the bona fide purchaser doctrine. He rejected a submission put forward by the banks that there were policy reasons against the application of constructive notice in commercial matters in the bona fide purchaser context, stating that he perceived there to be little evidence that paralysis would result. He also rejected the proposition that in commercial matters, constructive notice is narrowly regarded, distinguishing the decision of the New Zealand Court of Appeal in **Westpac Banking Corporation and Savin**. The judge indicated that the comments in that case were made in the context of the imposition of a constructive trust, stating that there was a difference between the notice required to constitute a receiver of property a constructive trustee and the notice that would be required to prevent a person from being a bona fide purchaser, with the latter requirement being more onerous. Once again, unfortunately, I must respectfully disagree with the judge on this issue. While there are occasions when the facts may justify such an extension, I have great difficulty in accepting that constructive notice should apply in the bona fide purchaser context.

Constructive notice is the knowledge attributed to a person by reason of position, conduct and means of knowledge of that person, independently of whether in fact they have knowledge. The limits of its application are (as evidenced by the remedial constructive trust cases) difficult to discern and rely to a large extent on judicial discretion. To seek to apply that concept to the bona fide purchaser doctrine, which is one of the principal doctrines of the law aimed at facilitating commerce, greatly to undermines its efficacy.

In determining that CIBC had notice in that it was put on enquiry, the judge rejected the submission that it would be an onerous task if the lender had to establish or make enquiries to establish the ownership of other moneys to be used by the borrower. He accepted that CIBC was under no compulsion either to act as policeman or to enter into the transaction, but stated that if the lender learns or suspects a breach of trust, then it should not continue to be involved in the suspect transaction, until its enquiries show a reasonable man that the suspicion is unfounded.

So, while the judge did not explicitly impose a duty on the lender to enquire, the result is, that if enquiries are not made the lender will be subject to constructive notice of those facts which proper enquiries would have revealed. No guidance is provided in the judgment as to the level of investigation that is required or what knowledge is sufficient to found constructive notice.

A number of questions arise:

When a lender is satisfying itself, does it do so by reference to a subjective or objective standard?

Must a lender show that it is satisfied that blatant impropriety (whatever that means) does not actually exist or only does not appear to exist?

To what extent can the lender rely upon assurances from the borrower about its conduct, where it is that conduct which raises the concern 'about things being in order'? In this regard some assurance can be obtained from the **Equiticorp** case (referred to earlier), where it was held that if one makes enquiries and has been given assurances as to the legitimacy of a transaction, in the absence of a clear indication that these assurances are not true, a lender is entitled to rely upon them.

Put simply, I believe that the test has become, a lender will be fixed with knowledge of all matters that it 'ought' as a result of its dealings with the debtor 'to have known', with the result that the risks to lenders of conducting their day-to-day business appear to have been greatly increased.

What then is to be done? One approach would be to adopt the attitude expressed to me by one senior Melbourne practitioner (admittedly late on Wednesday evening) that, because the decision is so off the wall, he intended to ignore it completely. If you are not that brave, however, I have the following practical suggestions.

Where lenders are proposing to take security, particularly in a situation where the acquisition of the asset subject to that security is contemporaneous, third parties also providing funds should be identified and inquiry should be made as to the terms relating to this funding. The nature and level of that inquiry will, unfortunately, depend upon the circumstances.

If possible, representations and warranties should be obtained as to the propriety of that third party's actions.

In a group situation, ratifying shareholders' resolutions should be obtained in respect of all up-stream transactions.

Finally, if possible, a legal interest should be acquired in the assets being offered as security for, while this does not remove the bona fide purchaser exposure (if notice includes constructive notice) it will provide some protection (in light particularly of the judge's response on the estoppel issue) where a court finds that an equitable interest arises but correctly applies the first in time maxim, in that a legal interest will (subject to the bona fide rule) always take priority over a prior equitable interest.

Unfortunately, I believe that the decision cannot be ignored. However, while practices may need to be revisited in its wake, overreaction perhaps is not warranted. In the end the facts were unusual and reflected a frenzied corporate climate not likely to be repeated in our lifetimes. **Linter** represented a borderline case even had the correct principles been applied and ultimately some comfort may be able to be taken from this.

WELSH DEVELOPMENT AGENCY

The decision of the English Court of Appeal in **Welsh**, in finding that the arrangements under consideration constituted a true sale rather than an unregistered charge, is of significance to practitioners involved with receivables discounting, securitisation and stock lending. In particular, it provides reassurance to securitisation practitioners that the inclusion of elements such as hold backs, recourse rights or limited put or call options, which are often critical to constructing the over-collateralisation required for rating purposes, in a manner that does not render the product uncompetitive from a pricing perspective, do not of themselves render the transaction a secured borrowing rather than a true sale.

The importance of the case centres upon this issue. The facts, given in my experience, the unusual undisclosed principle structure adopted, are not of critical importance. A brief review only will be sufficient.

Parrot Corp Limited was a computer disc exporter with two main sources of finance. Welsh Development Agency guaranteed Parrot's revolving credit facilities and took security in the form of a registered debenture over Parrot's assets. Export Finance Company Limited provided trade finance under a master agreement recording what was, in substance, a receivables discounting arrangement. Parrot's business was unsuccessful and the Development Agency appointed receivers under its debenture. The case involved a contest between the Development Agency and Exfinco over Parrot's major asset, namely amounts received, and amounts owing, from sales to overseas buyers.

The Development Agency, as debentureholder, succeeded in the High Court with the argument that the master agreement was an unregistered charge, rather than a sale. The judge regarded the following factors as determinative:

1. The price payable by Exfinco to Parrot was 90% of the price payable by the overseas buyer less a discount fixed at the time of the transaction, but later adjusted by reference to the time it took all overseas buyers to pay.

2. Parrot had what was referred to as a 'right of redemption'; if Parrot terminated, it was liable to pay Exfinco a sum equal to all amounts owed by overseas buyers. In return Parrot would acquire Exfinco's interests in the discs and the debts of the overseas buyers were relinquished in favour of Parrot.

3. Exfinco had a 'right of retention' in that it was entitled to deduct various amounts from sums payable to Parrot as a safeguard against the possibility of there being other sums to deduct in the future.

The majority of the Court of Appeal found that the master agreement was a sale and not a charge. The court referred to the decisions of **Re George Inglefield Limited** and **Lloyds & Scottish Finance Limited v Cyril Lord Carpet Sales Limited** and concluded that:

1. There may be a sale of book debts, not a charge, even though the purchaser has recourse against the vendor to recover the shortfall if the debtor fails to pay the debt in full.

2. There may be a sale of book debts, even though the purchaser may have to make payment adjustments to the vendor after the full amounts of debts have been recovered from the debtors.

3. A right of redemption is not inconsistent with the transaction being one of sale and does not necessarily imply a charge.

The court indicated that where the document is not a sham, the courts will have regard to the description which the parties have themselves given to the transaction in determining the nature of the transaction.

The court rejected any notion that it should be more hostile to a transaction because it amounts to off balance sheet financing, observing that those who provide credit on security could, if they considered it necessary, (and often did) insert provisions which would prohibit the use of the sort of arrangement set out in the master agreement.

While the **Welsh** decision appears to resolve the uncertainty (as to the proper approach to apply in determining the legal nature of a transaction) occasioned by the High Court decision, practitioners (or New Zealand practitioners at least) need to be aware of the decision of the New Zealand Court of Appeal in **NZI Bank Limited v Euronational Corporation Limited**. In that case the court had to consider the approach adopted by the judge in the New Zealand High Court, where he reached his conclusion on what was described as a 'pragmatic' or 'substance not form' approach to the process of determining the nature of the legal arrangements involved. Of the three judges sitting in the Court of Appeal, Mr Justice Richardson did not accept and indeed openly criticised this approach. Instead he examined the legal arrangements entered into and effected and indicated that determination as to whether there had been a breach of the relevant statutory provision (with which the case was concerned) should be decided on established principles. It is worth quoting here a short excerpt from the judgment, which encapsulates, what is, I believe, the proper approach to this issue:

> *'The legal principles are well settled. First, the true nature of the transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out. It is not to be determined by an assessment of the broad substance of the transaction measured by the overall economic consequences to the participants.'*

On the other hand, President Cook and Mr Justice Gault did not consider that it was proper to confine an analysis of the scheme to considering the terms of the arrangements against the factual background; evidence of the actual purpose the directors were pursuing is relevant. So, while great comfort can be drawn from Mr Justice Richardson's rejection of the test adopted in the High Court of initially examining a scheme in terms of its substance and broad economic terms, the views of the other two judges need to be taken into account. However, these views also need to be taken in context. The case involved the consideration of whether a breach of a statutory provision had occurred. The provision required the directors to be pursuing a 'purpose'. As such, I believe that the only rider that needs to be placed on the views expressed by Richardson J is that it is clear from the **Euronational** decision that while the form of a particular scheme is important, any blatant attempt to 'subvert the policy of the legislature' may be viewed with some scepticism by the courts. I do not believe that such a consideration is relevant to the determination of whether documentation produced for a receivables discounting or like transaction records a true sale or a secured lending.

From a lender's perspective the comments of the court in **Welsh** to the effect that lenders can insert provisions in their documentation prohibiting these sorts of arrangements, has obvious significance. The form of financial covenants and warranties may need revisiting in light of **Welsh** or, more particularly, given that **Welsh** did not change the law in this regard, the burgeoning growth since the mid-80s of off balance sheet financing. Prior to addressing this issue however, I wish to consider briefly the provisions of International Accounting Standard Exposure Draft 40. IED 40 is the draft statement issued by the International Accounting Standards Committee for the accounting of financial instruments and contains provisions dealing, in particular, with the discontinuance of recognition of a financial asset or a financial liability and for the offsetting of financial assets and financial liabilities. The statement is (I understand intentionally) extreme in its effect. For example, paragraphs 30 and 33 provide that receivables sold pursuant to a factoring or securitisation should remain on balance sheet, if the purchaser has the right to receive compensation from the vendor for **part** only of the economic loss arising as a result of delinquencies. However, some comfort can be taken from the fact that the draft statement produced by the Australian society (ED 56) ameliorates some of the more extreme positions expounded in IED 40, proposing, in the case of asset dispositions, a recognition test that more accords with the legal approach to such transactions (although I understand that controversy exists in Australia as to the breadth of its application). In New Zealand FRS 31, which deals with disclosure only, has been introduced. A separate statement dealing with recognition and measurement is to be introduced shortly. It is to be hoped that in this regard the New Zealand society follows the lead of its Australian counterpart.

If introduced, I believe IED 40 would operate in a manner similar to typical central bank requirements for removing assets from a registered bank's balance sheet for capital adequacy purposes. It is possible therefore that, typical central bank guidelines might (among others) applies. For example, in respect of a receivables securitisation.

The vendor would not be able to retain any beneficial interest in the debts being transferred and the purchaser would not be able to have any recourse to the vendor in respect of losses.

The purchaser would not be able to require the vendor to have any obligation to re-purchase the debts at any time (although the vendor may retain an option to do so, provided the debts remain fully performing).

The documented terms of transfer would have to be such that if a debt is rescheduled or renegotiated, the purchaser and not the vendor would be subject to the rescheduled or renegotiated terms.

Where payments are routed through the vendor, it would have to be under no obligation to remit funds to the purchaser unless and until they are received from the debtor. Payments voluntarily made by the vendor to the purchaser in anticipation of payment by the debtor would have to be made on terms under which they could be recovered from the purchaser if the debtor fails to perform.

The effect of adopting a standard in the form of IED 40 needs to be carefully considered therefore, as unamended it would lead to increased pricing, given that elements such as limited recourse rights and put options would no longer be able to be permitted as forming part of the over-collateralisation required for rating purposes, if the corporate wished to take the assets off balance sheet. If, because of the manner of construction of the over-collateralisation, the standard could not be complied with, the assets would remain on balance sheet on the basis that the transaction was a secured lending for accounting purposes (with a note being added to the effect that the relevant assets had actually been sold), resulting in the unfortunately more common situation where accountants say it is not a true sale for accounting purposes, but lawyers say it is a true sale for legal purposes. If this were to occur (while the accounting treatment is not determinative from the point of view of ascertaining the legal nature of the arrangements entered into), I believe that nervousness in the legal market would result, with opinions on the issue being qualified, particularly when it is borne in mind that the prevalent accounting view (where a hold back or recourse element exists) appears to be that, regardless of how carefully it is structured, the special purpose vehicle is an 'in substance subsidiary' of the corporate for reporting purposes.

As I have said, the court in **Welsh** indicated that, if a lender wishes to prohibit the entry into transactions such as receivables discounting or securitisation, it has the ability to do so by inserting appropriate provisions in its documentation. In making this statement, I believe that the court envisaged the insertion of specific covenants to this effect. Notwithstanding this, however, the practice appears to be growing, particularly in Euromarket documentation, to seek to prohibit such transactions by means of expanding the definition of 'security' or 'security interest', and therefore the operation of the negative pledge.

Here is an example of this, which comes from a Euromarket facility agreement:

> *'**Security**' includes any mortgage, pledge, lien, hypothecation, security interest or other charge or encumbrance and any other agreement or arrangement having substantially the same economic effect (including any 'hold back' or 'flawed asset' arrangement).*

It is by the addition of the words 'and any other agreement or arrangement having substantially the same economic effect' (the following words in brackets, to my mind, adding nothing) that it is intended to encompass off balance sheet transactions within the negative pledge. However, I have a problem with this practice, in that the exact scope of these words is unclear. They are open to differing interpretations and this lack of clarity means that the scope of the negative pledge is also uncertain. Read literally, these words catch many transactions which most practitioners would not regard as 'securities' and therefore subject to negative pledge restrictions. For example, this definition would catch a hold back and recourse element in a receivables securitisation. But is it only that element that is caught? Could not the entire transaction also be encompassed (particularly if, for accounting purposes, the disposition is not treated as a sale in the corporate's accounts)? Additionally, a transaction where no asset nor liability of a group is created could also be covered. For example, the 'flawed asset', limited recourse and set off rights granted to a bank by a company in respect of a deposit, which the bank utilises to on-lend to a related company of the depositor (a previously common structure in New Zealand, which had certain fiscal advantages) could constitute a security, even though, for accounting purposes, it is accepted that the credit risk on the intermediary bank is eliminated (by means of the utilisation of appropriate set off and other covenants) and therefore that both the asset and the liability eliminate on consolidation. What are the determinants of 'having substantially the same economic effect'?

I believe that this expansion of the definition of 'security', with the intention of prohibiting off balance sheet financing, should not be encouraged, in that uncertainty as to the scope of the negative pledge and therefore the prohibition results. This is neither beneficial to lenders nor borrowers. In the absence of a clear restriction (the lender's intentions in this regard, to some extent, being hidden in a definition, rather than expressed openly in a restrictive covenant), a borrower will be uncertain as to whether a transaction all regard as 'above board' (such as a properly structured securitisation which complies with accounting non-recognition standards) is prohibited or not, while a lender, faced with a recalcitrant (or belligerent) borrower which implements transactions the lender wishes to prohibit, will be uncertain whether, in fact, the borrower has created a 'security' in breach of the negative pledge and will therefore be reluctant to act, given the consequences that may flow if it is wrong.

If lenders wish to prohibit off balance financing they should do so clearly and unambiguously through the inclusion of specific covenants to that effect (as advocated by the court in **Welsh**), thereby resisting a recent and (sometimes) frustrating trend of immediately inserting in local documentation a solution to an issue dictated by London practices, which may be particular to the Euromarkets.