CURRENT ASPECTS OF UNSECURED LENDING
SUBORDINATION

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It is indeed your lucky day, because I was going to say quite a few things and I am now going to be very brief. Subordination is a way of raising capital, it is also a device used by banks when they are lending down the corporate tree.

Assume that you have a special purpose company which has been established to get off the balance sheet of a larger group, to get round all of the ratio clauses that everybody else on this table loves, or assume that you have got a project company that has a few sponsors investing in it. You have the banks - because I always get confused between senior creditors and junior creditors I will call them the "good guys" - lending to the company. They will want to lend on an unsecured basis and will want to make sure that the company has a certain amount of equity and a certain capacity to pay its obligations as they fall due.

You have the sponsors or the owners of the company who have lent that company some funds. The banks may want them to lend the borrowing company more funds in order to be able to ensure that the company has the capital. We will use a technical term for them - the "bad guys".

Maurice Cashmere has gone into a lot of the legal problems that there are when you try to ensure that in a winding up of the borrower you have an arrangement where the bad guys don't get any money and the good guys get it all without running into problems as to the law of liquidation in the winding up of a borrower. But in many of these situations when you are examining the credit, if the borrower goes belly up it is just as likely - and indeed it is on the cards - that the bad guys are going belly up as well.

In those cases you have got to make sure that the arrangement does not only work in the winding up of the borrower but that it also works in the winding up of the bad guys. And the problem is you have heard that it is a general rule of public policy (as applied in British Eagle [1975] 1 WLR 758) and under ss.403 and 440 of the Companies Code that the assets of the company have to be available for all unsecured creditors. Unfortunately here the assets of the bad guys include the debts that the borrower owes to them.

What you will want to try and ensure is that you have some sort of arrangement under which those assets either disappear or are limited in some way, or you have access to those assets so that, for instance, if in the liquidation of the borrower, or some other reason, the borrower pays some money up to the bad guys and the bad guys get hold of some money, that money goes to the good guys.

The difficulty with all of that is that any arrangement under which the good guys try to get money out of the liquidation of the bad guys in preference to all of the other unsecured creditors of the bad guys will strike into the very problem that we have been talking about before.

Now there are various solutions to that problem. One solution is to say that the bad guys hold those moneys on trust for the good guys. I do not have time to go into it but I respectfully disagree with Maurice and I think there is a very strong danger that almost every situation you try and create would make that a charge, it would be registrable, you would have stamp duty problems and you would breach any negative pledge of the bad guys.

The other arrangement which has the greater chance of success is to play around with the nature of that asset itself and to do what was done in the perpetual floating rate note issues and either to make the debt from the borrower to the bad guys contingent on the borrower being solvent or in some way to say that it is reduced automatically and will only crystallize in certain events. That I guess is generally known as the "flawed asset theory" and probably works as it is altering the nature of the assets available in the winding up and not affecting the way those assets are distributed. But if the banker comes to me as a cynical lawyer and says: "We want a document which will work" because the banker has not taken account of John Patten's and Richard Youard's advice and does not trust the credit, then unfortunately I would always have to say to them as a cynical and conservative person that the arrangement will only <u>probably</u> work - it is not beyond doubt.

The difficulty occurs if you look at the judgments of the majority in the House of Lords case. It is always open for someone to try and say that playing round with the nature of the asset was designed to get round that public policy, particularly if that asset, the debt that the borrower owes the bad guys, was already in existence before you entered into the subordination arrangement. If you look at the minority judgments a flawed asset approach was precisely the argument of Lord Morris who said that the asset was different, that the debt in question was not a debt owed directly at all. Unfortunately that argument was not accepted by the majority and it may not work if the case was ever brought to trial.

Hopefully commercial good sense will prevail and the courts will uphold what is a necessary part of commercial life but you can never be sure that on the facts that type of technical argument may not defeat it.