CAPITAL MARKETS FUNDING - LEGAL DREAM OR NIGHTMARE?

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I was glad that Tom Bostock brought in the subject of nightmares. The only thing is he wasn't really gloomy enough. The position is not that you have to worry about somebody coming waving a piece of paper in one hand and a writ in the other - that you can more or less cope with. What you are worried about is the man coming up behind with his lawyer and no piece of paper who says: "Hey, that isn't a negotiable instrument. I sold it to him but he has not paid me and you cannot pay him unless you pay me as well".

That is when you get into real trouble. You only avoid that if you have a negotiable instrument. If you have a negotiable instrument you can pay the man who produces it and ignore any other claims at all. Thirty years ago when the capital markets funding began in London on any significant scale the Accepting Houses Committee, which is the bluest of the blue blood (they are the people who can go into the Bank of England as a lender of last resort) took the advice of Bob McKendrall who was then leader of the Commercial Bar in London. This advice concerned the issuing of the first CDs (remember the point about a CD is it contains no promise to repay). McKendrall was asked: "Can we issue these things in London and will they be negotiable instruments?".

The Accepting Houses Committee was advised that they could provided a market was made in them, and provided the market treated them as negotiable and there was sufficient evidence of that. It was considered then that it would take about a year for CDs to become truly negotiable so that you could say to the man coming up behind: "I am unpaid, go away, we are only concerned with the four corners of the piece of paper and whose sticky hand is holding it".

Now that was and is the legal position and it won't change because negotiability is a characteristic of the law merchant, not of the common law itself. Those characteristics were laid down more than 200 years ago, and they are not going to change, or there is no reason why they should change, with certain very limited exceptions which we have not got time to go into today. What has happened since then is that more and more documents have come onto the market which look very similar to those the market

is already accustomed to. Therefore they are the more easily digested. I have no doubt if you were brought up on wichetty grubs you would like them but if you had never seen one before you are unlikely to swallow one. And therefore you have to produce a document which the market has seen before. The time-scale of the advice which bankers have been getting in the City of London over the last 30 years is that it no longer takes a year to make a new instrument brought to the market acceptable; it has come down to 6 months, 3 months, 3 weeks and in many cases now, we say frankly, by the end of next week or this week - starting on the Monday - this document will be treated as negotiable because it is something the market knows about. But what gets in our way when we are trying to do that, and I make no chauvinistic point about it, is that the New York lawyers have never heard of the law merchant and don't understand negotiability. We are asked to comment on documents drafted in New York; we just take a red pencil and scrub out everything they put on in New York and say that is OK. I kid you not. That is exactly what happened, for example, in the Kingdom of Sweden issue made last year which was enormous and very very successful. And when it came from New York it looked like a telephone directory and when it went out it was in large print on one side of one piece of paper. It has been a very successful issue.

What is a negotiable instrument? The important thing about a negotiable instrument is that the person who is liable on it and the person who has got it in his hand know precisely what the liability is and the benefits are from the four corners of the instrument, if necessary supplemented by publicly available information. If you need to go to anything else then it is virtually impossible to achieve negotiability. So for example, this morning I was grateful when Roger Zimmerman discussing floating rate notes referred to pre-determined rates because provided they were pre-determined then the rate is certain. But if the rate is prescribed by something which may happen thereafter which is not <u>necessarily</u> public knowledge, then the rate may not be certain, and the document is incapable of being declared to be a negotiable instrument by the courts. For that reason bank rate as it used to be in England, minimum lending rate and references to points up and down are acceptable rates which do not detract from negotiability.

For myself, although it is used, I have grave doubts whether LIBOR is acceptable because it has got to be declared by banks and usually by two reference banks in London at the time. I do not regard that as publicly available information. Someday, somebody is going to find that at the LIBOR rate he is going to come unstuck and it is not a question of somebody buying in the market being difficult about it. You have always got to think of the bloodiest minded man on earth, which is a receiver or a liquidator, who is in funds; he won't let go because he has got absolutely nothing whatever to lose. If you want a very good example of exactly that but not in this field, you have only got to think what the liquidator of Laker Airlines did to British Airways and half of United States Airlines over the last few

years. He has held them up for 36 billion or something like that very very successfully and in a way which no ordinary litigator can do. You must always make sure you are out of any potential clutches of a liquidator or a receiver.

Now that brings me directly to the security of these instruments etc. If you have been successful and obtained a negotiable instrument then remember that the only person that you look at is the chap who produces it and waves it at you on the due date. In 1982 there was a brilliantly successful theft from the offices of an Israeli bank in London, a small envelope was stolen, containing nine pieces of paper, negotiable instruments to a face value of US$10,000,000. They turned up eventually from impeccable sources; they had to be paid. The Israeli bank was a little bit unhappy as well because it had to pay the person who deposited the documents with them. There were plenty of banks who do not quite have the AAA rating, in fact probably have a CCC- rating, who are nevertheless able to make a good deal of money because they assist in the laundering of such documents and those documents go out to South America and come back to Zurich, they get transferred to Geneva and turn up in respectable hands in London, and have to be paid.

The moral is make sure that those documents stay in a safe place. And what is a safe place? That is the role of the custodian bank and in London, First National City Bank of Chicago, have pretty well cornered the market in providing a service as a custodian bank in order to take possession of notes and hold them, and then they hold them to the order of the person who claims to own them. The notes themselves always stay in the vaults of the bank and if you transfer the note from A to B, A and B jointly inform FNCB that B now owns the note and it remains in safe custody. Otherwise at some stage somebody is going to put it into a briefcase, walk round the City of London and lose them. FNCB had the idea that to avoid the risk of these documents being stolen, why not put them into the computer and not print them out until they were asked for; then they would be perfectly safe, wouldn't they? But what is the thing that is negotiable? You haven't even got a note at all. If you don't even start with a note it is not capable of being negotiated. That was an idea for security which didn't work at the end of the day.

Lastly, looking at the attempt to keep the assets of the person who has lent the money secure, which is what I regard as the trustee's job, there are two aspects. One of these has become very common nowadays: that is looking at the floating rate interest to make sure you are not locked into something which over a period of time ought to have a different rate on it. What has not caught on so well is the basket of currency notes which is intended to preserve the totality of the capital obligation.

There was a proposal a few years ago to have notes denominated in special drawing rights. That is the SDRs on the IMF. Of course only governments can draw on SDRs. You can make the money of the account pay out in any basket that the person who holds the notes

at maturity asks for, or in the mix which he has currently prescribed at the time. So you have your currencies intact on a world basis. There have been very few issues of that kind. What has taken off instead in London, is the ECU market which is the equivalent in the Common Market to a basket of the common market currencies, and both borrowers and lenders who are largely exposed to the area of the common market find it extremely convenient to uphold the capital liability denominated in the basket. This is comparatively immune to fluctuations because it stays around the middle of the stake, and at the end of the day you are paid out with undiluted capital, notwithstanding whatever currency you put in in the first place. So if I were counsel to a trustee at the outset, I would say: "Well wait a moment, if I am trying to protect the capital interests of the lender why not protect the capital itself, the money of account, by going into a basket". And certainly the ECU market has taken off in London in a very big way, that someone with a worldwide exposure might still be interested in SDRs. There is no technical problem about it at all. And the last thing as counsel to the trustee, I would say "Mr Trustee, are you really necessary?". In so many cases trustees exist and they have to earn their fees. We will come later to what they can do. My personal preference is to have a fiduciary agent who can collect on behalf of the bond or note holders if necessary; his whole job in effect is to represent them; he has no responsibilities as trustee.