CAPITAL MARKETS FUNDING - LEGAL DREAM OR NIGHTMARE?

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My function is to outline the position of the issuer's Australian lawyer in relation to Euromarket issues. There are I suppose five principal functions for the issuer's Australian lawyer.

First, his task is to examine and advise the issuer on the documentation of the issue.

Secondly, he should check that a section 14C certificate has been obtained before the issue closes if, as is almost always the case, there is a point of contact between the issue and a tax haven; and also that an application has been made to the Commissioner of Taxation for a ruling that, provided he is satisfied that the issue takes place in the way to satisfy the distribution requirements of section 128F, a certificate under sub-section (4) of that section may be expected to issue.

Thirdly, he should check the liability of the stamp duty in any relevant Australian jurisdiction of the issue documentation.

Fourthly, he should check that the issue documents or the manner of the issue will not bring about a breach of domestic Australian companies and securities legislation.

Finally, and from his point of view most personally important, he has to issue the customary opinion to be delivered at closing as to the existence of the issuer and the enforceability of the issue documentation.

I will perhaps start with the last matter because, bearing in mind the title of this session "Legal Dream or Nightmare?", I think it might be time now to move into nightmare country. Imagine if you will that an issuer goes broke and as the issuer's Australian lawyer you find hordes of people waving their bonds in one hand and the writs in the other claiming against you for something that you might negligently have said or omitted in your opinion. The numbers these days are so large as to defy belief. Fortunately the design of these opinions has to a degree become an art form and the opinion part of it is usually hedged and flanked by carefully drawn assumptions on the one hand and elaborate qualifications on the other, so that there is a fair measure of protection.

I would like to draw your attention to an article in the February issue of the International Financial Law Review by Tom Poulton of Arthur Robinson and Hedderwicks headed "What to look out for in Australian Legal Opinions". He draws attention to almost all of the banana skins on which a lawyer giving such an opinion might slip and it is a highly readable and useful article to have at one's elbow when actually fashioning an opinion. All I would say here and now on that side of the matter is take care to limit the number of possible plaintiffs as far as you can. Say at the end of the opinion who you are giving it to - that is to the managers, the underwriters, the trustee - and that it may be relied upon by them and, if you have to say so, by their advisers, but then add without necessarily underlining it, that it may not be relied on by anyone else. With a bit of luck it might do something.

But there are many other nightmarish aspects I would draw attention to whilst on the opinion because the opinion will direct itself to the question of domestic stamp duties and domestic securities regulations. Taking stamp duty, I may revert to that if I have time a little later on, but in a broad sort of way one takes the view that the documentation of an issue in the Euromarkets or in the commercial paper market in New York, doesn't attract stamp duty in Australia because it is executed outside Australia and none of it (if properly drawn) will relate to any property in Australia or anything done or to be done in Australia. In terms of the Stamps Acts themselves the documentation lacks nexus with a particular Australian State or Territory for stamping purposes.

The main area with Companies and Securities legislation is of course the prohibition on making offers or invitations of securities to the public without registering a prospectus. Unlike the Stamps Act, the Companies Code doesn't define things in its own geographical terms, and linguistically at least the prohibition could apply to an offer by a Victorian company to sell securities to the public in, for example, Outer Mongolia. But the view seems generally to be taken that the section refers to what is done within the particular State or Territory again of that particular Companies Act or Code, thus in Victoria it will be in Victoria and so on.

Some of our thinking in this regard may have to be revised with the passage of the Australia Act 1986. This is better known for cutting our remaining umbilical ties to the United Kingdom and finally finishing off Privy Council appeals. But one section which I think is worthy of attention in this forum is section 21 which says very simply "it is hereby declared and enacted that the legislative powers of the Parliament in each State include full power to make laws for the peace, order and good government of that State that have extraterritorial operation".

Now, I make no pretence whatever of being knowledgeable in constitutional law; but the fact that it should have been thought necessary to enact that section suggests there must be something in it, and it is not insignificant perhaps that the eye of the Victorian Comptroller of Stamps' right hand man Mr Frank Brody has also fastened on it when he says "finally in the context of extraterritoriality reference will be made to the recent enactment of the Australia Act 1986 which amongst other things bears on the question of a State's extraterritorial powers". Well you can make of that what you will but it could be that we shall see some stormy weather coming with it. It could perhaps be a topic for our next conference.

Passing now to more mundane matters, let us start with the documentation. This is particularly important in the case of a first issue because subsequent issues by an issuer tend to follow the pattern of the documentation of previous issues. If, for example, one gets away with a very lenient negative pledge on the first issue, it gives one a good negotiating position next time around. There are certain issues with documentation that are negotiable and there are certain issues that are not. Among the latter is of course the obligation to repay. But also, and more relevantly, the obligation to repay free of any withholding tax. That is it is axiomatic in the Euromarkets that if interest on the bonds should attract Australian withholding tax it is for the account of the issuer. Whilst in a syndicated loan it is possible to negotiate an arrangement under which the borrower can claw back, as it were, the benefit of a tax credit that the lender may get for the withholding tax paid, that is totally impractical with a normal note or bond issue.

On the other hand, there are some negotiable areas. Days of grace are always nice to get if you can because it is always possible that something can go wrong in the international payment system, and an extra few days could prove invaluable for the issuer: one should certainly try for it. It is not possible to do it in some markets, particularly the commercial paper market in New York where days of grace are unknown; but in other markets they can, depending on the muscle of the issuer, be obtained.

Then, there is also the negative pledge which is an almost invariable requirement on the note issues. The rationale for that is perhaps a little different from that in domestic lending arrangements, where it is primarily a matter of security. My understanding is that in the Euromarkets at least historically the importance of the negative pledge was primarily a matter of marketability: there would be difficulty in selling unsecured bonds or notes without the assurance that the same issuer would not come into the market shortly afterwards with a secured issue. With that in mind it is quite logically possible to try to exclude from the ambit of the negative pledge, say, domestic secured indebtedness within Australia. If you are a miner you could seek to exclude, for example, limited recourse finance or secured debt arising in the normal course of business.

The issuer's lawyer must also be on the look-out for peculiarities of Australian law affecting the documents: a well-known example of that is section 16 of the Banking Act under which in the event of a bank becoming insolvent the assets of the bank, at least within Australia, are to be applied in discharge of the bank's deposit liabilities in Australia before any other liabilities. Obviously mention must be made of that in any prospectus or information memorandum relating to an issue by an Australian bank. Likewise, there is a section in the Reserve Bank Act which gives priority to indebtedness of a bank to the Reserve Bank over indebtedness to other creditors.

The third aspect is taxation, and there one's concern, of course, is withholding tax: as Euromarket issues proceed invariably on the basis that the buyer of the bond or the note does not pay any withholding tax, it is essential somehow or another to keep outside the withholding tax net. There are two ways in which that can be done. One is that where the issuer is to raise funds for use by an offshore permanent establishment. Well that is totally outside the withholding tax net in terms of the legislation itself and that is not infrequently seen. The other more frequent way is to go under 128F of the Assessment Act which exempts from withholding tax interest on widely held bearer securities denominated in a currency other than Australian. Rob Douglass has referred to the difficulty raised by the requirement for denomination in a non-Australian currency, and has I think made the point that it seems at this stage anomalous that such a limitation imposed as long ago as 1971 still remains around with the deregulation of our financial markets. It certainly leads to quite a lot of complexity where borrowers wish to go as far as they can in denominating their note or bond issues in Australian currency without losing eligibility for exemption under the section.

The other problem is of course that exemption of an issue under 128F is never settled until after the issue has been completed. The certificate on which exemption depends can only be issued after the Commissioner is satisfied that the securities in question were issued for public subscription or for other wide distribution among investors. That of course impacts on the opinion, because the opinion is released naturally before the issue is completed and the issuer's lawyer is generally required to advert to the point. If at all possible he should try to get away with a statement saying "provided the Commissioner issues a certificate under sub-section 128F(4) no withholding tax will be payable". Unfortunately, he is often expected to go further and venture a prediction on the likelihood or otherwise of such a certificate being issued. That can be particularly difficult with note issues perhaps rather than bond issues, because they are taken up generally by a panel of underwriters or a tender panel which in itself would not normally be classed as a wide range of investors.

Some light has been thrown on that by a recent ruling of the Tax Office; ruling number 2238 of December 30, 1985. It was accepted that notes issued in accordance with the proposed tender panel arrangements would be issued with a view to public subscription or purchase or other wide distribution among investors as required by para. 128F(4)(a) of the Assessment Act. "The size of the note issue, the denominations of the notes and the marketing arrangements under which the tender panel members would bid for notes against firm orders received by them from customers in advance of the issue were taken into account in reaching that decision. However, a review of the arrangements would be necessary should there be evidence of any of the parties consistently retaining the notes." That somewhat sibylline utterance clarifies things to some extent; the last sentence perhaps raises more doubt than it solves.

The other topic is the question of bearer securities or registered instruments. It has always been a cornerstone of the Euromarkets that the securities be payable to bearer, so that the scope for registered instruments in a market sense is extremely limited. In any event registered securities would not be entitled to withholding tax exemption under section 128F.

Moving on from that to selling restrictions, mention has already been made about the absolute desirability of avoiding the need to register in the United States with the SEC; and that is achieved by virtue of a ruling made in the United States in about 1964 to the effect that, so long as the bonds or notes are withheld from sale to residents or citizens of the United States or for resale into the United States, then registration will not be required. In the United Kingdom the requirements are similar to ours under the Companies Code; but where the issue is by an overseas company or a company incorporated outside the UK and the issue is made (as these issues invariably are) to professional investors, then registration or a prospectus is not required. I have already dealt with the situation under Australian law; but the effect of the Australia Act on securities regulation remains to be seen.