CAPITAL MARKETS FUNDING - LEGAL DREAM OR NIGHTMARE?

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Rescheduling

First of all I want to apologise to you for the use of the dirty word "rescheduling" in the context of capital markets. It is absolutely unthinkable to reschedule in the capital markets. Bankers as you know, when people fail to pay the bank money, are very reluctant to write off bad debts. What they do is they say to the lender, so long as you keep paying us something, that is all right, we will just extend the maturity a bit longer. As you know, we do that with the house mortgage market from time to time, so that we can say that all of our debts are good and we do not have to make any bad debt provision for them. But in the bond market, as Richard has said, because we are dealing in negotiable instruments which people are trading on a "name" basis and on a fixed price, calculated on how much we feel it should yield for a particular maturity, those pricing considerations go completely askew if somebody says "oh, by the way, the maturity is not five years it is now seven years", or even worse - indefinite.

Remember we are dealing with a market place with a large number of holders of bonds and where they insist on, in many cases, anonymity. I would like to mention in the context of Tom Bostock's discussion of section 128F,* that section gives managers a lot of trouble, because there is a sort of an attempt there by the taxman to penetrate the veil of anonymity that is so important in our market. I will say nothing of the dilemma of the manager who thinks that the securities are very attractively priced on a particular roll over and would like to hold them all for himself. Meanwhile he is having to demonstrate to the Australian Tax Commissioner that he has sold them to seven or eight or twenty-eight people.

I wanted to give you some "war stories" about five headings:

(i) changing the terms of an issue;
(ii) rescheduling;
(iii) enforcement;

(iv) fraud; and
(v) unwinding a swap.

Changing the Terms of an Issue

Changing the terms of an issue is not a very happy thing to do. In 1975, when the market finally reopened after the Herstatt catastrophe, I was involved as a lead manager for the first issue to come to the market, a floating rate note for Austraswiss. There we had a trustee set up and we sat down and thought very hard about the issues, the things that he could change and could not. We agreed that he could not change the currency; he could not change the maturity; above all else and obviously he could not change the interest rate. But the trouble about the interest rate, was that it was calculated on LIBOR and we just did not know whether LIBOR was still going to be extant or not, during the currency of the loan. So we finally decided that the trustee could by some process have reference to another rate. Of course, it was this whole issue that got us into the area of whether the notes were negotiable or not.

The other famous case of course, and I am sure that they will not appreciate me mentioning it, was Jardine Matheson who got conned in the early 70s by some over-enthusiastic lawyer into a US style negative pledge language and suddenly realised that there they were completely constricted as to what they could do. They could have prepaid the issue (at penalty rates) and refinanced at a higher rate. Not a very pleasant alternative. So instead they actually had the trustee call a debenture holders' meeting. They had to get two thirds of the debenture holders represented at the meeting to vote to change the absurdly tight negative pledge covenant and of course, talk about penetrating anonymity, it was an awful hash of a thing. So changing the terms of an issue is not something that we would recommend. Do it right in the first instance.

Rescheduling

I have to confess there is one hideous, appalling precedent for this in the bond markets. It was a company called Adela, which was an investment company owned by about 176 different banks located all around the world, with the exception, I am pleased to say of Sydney. It decided that it could not pay its debts just before the Latin American banking crisis, because I think it was heavily involved with the Alpha group in Mexico which had gone broke. Blow me tight and goodness, if they did not have a note holders' meeting and the trustee duly agreed to reschedule the issue. Thank goodness this dreadful precedent was never followed. As a former lawyer, I would "distinguish" this precedent by pointing out that the note holders were almost certainly the 176 banks who were shareholders, hence their failure to realize the appalling breach of bond market etiquette they had committed.

Somebody asked me out in the corridor what had happened to the poor old Japanese investors whom we had stuffed with Mexican bonds. The answer, I am pleased to inform you, is that, of course, they have been and continue to be paid on time. In the rescheduling discussions with the Mexicans, it was agreed that bonds and notes would be treated separately from bank loans. This is because banks are sophisticated people, who can live with the different maturity; whereas bond holders are very unsophisticated people, who simply want to be paid out in full on the due date.

Enforcement

There have been some examples of enforcement in the market, again I regret to say that I was involved with one of them. Maritime Fruit Carriers was an Israeli shipping company that sold floating rate notes secured by ship mortgages and assignments of charter hire on some fruit ships. The trustee succeeded in arresting the ships. The company brought suit to say that the investors were simply involved in anti-Israeli activity because they wanted to favour the Arabs (it was at the time of the first oil crisis). However, I am pleased to say the courts upheld the security and the rights of the bond holders. The investors got paid in full eventually. What a time consuming affair it was.

Fraud

Well we have already had one story of theft, but there is another story where someone got caught with 40 million dollars of forged General Foods zero-coupon bonds. The forger picked zero-coupon bonds, on the thesis that since there was no coupon to be paid for ten years, nobody would bother to pull the bonds out of the cupboard for ten years and therefore the villains would be well and truly away by the time that the fraud was discovered. Unfortunately an exceedingly sharp eyed chap - I think it was the principal paying agent - noticed that the validating fiscal agent's signature on these bonds was not an original signature, but a facsimile. In fact I believe that some people were eventually caught. But interestingly, where there were holders in due course, as I think there were, I believe they were paid in full on the grounds of keeping the negotiability of the market going. I guess somebody, the paying agent who had accepted the bonds for entry into the clearing system had to bear the cost of that.

Unwinding a Swap

Last but not least is the question of unwinding a swap. I again am sorry to admit that I have some experience of this as well. Well, I am not too sorry, because fortunately we made some money out of it. It was only about a month or two ago. Westpac did a warrant issue for the Union Bank of Norway. We sold warrants to the public in exchange for cash. Those warrants entitled the holder to convert to A$100 million 14% bonds of the Union Bank of Norway. Now of course the Union Bank of Norway has as much

interest in Australian dollar bonds as I have in extraterrestrial navigation. What the bank really wanted was floating rate London Inter Bank Offered Rate US dollar deposits, or more to the point <u>under</u> LIBOR deposits. So they entered a swap arrangement. This story illustrates both the dangers and the difference between bonds and swaps. The deal of course had to be consummated quickly. The financial institution in Australia who was on the other side of the deal said "Right! Dealt! We'll undertake to indemnify Union Bank of Norway for the liability that they have assumed to the holders. In exchange, we get a little payment up front and in addition we will provide them with a different liability of floating rate dollars". So that was a classic sort of swap situation. Then it was discovered, because this of course all took place in a space of about three or four hours, that is was beyond the powers of the financial institution in Australia to enter such an agreement. The only problem was the warrants had already been sold by us to the public. So that part of the deal was set in concrete. Now needless to say we did not pick up the liability to the issuer. What we did was scurry around damned quick and find some other people who were prepared to take on the swap liability instead. It was really quite funny because meanwhile a US investment bank, similarly placed, kept ringing us up every day or two saying "what are you guys up to?". Fortunately for us the interest rates in Australia had gone the right way, and so we were able to unload the position. I leave you to imagine what the position would have been had the interest rate gone the other way.

* No longer relevant, as the Treasurer has foreshadowed legislation to repeal this exemption from withholding tax.