CURRENT ASPECTS OF UNSECURED LENDING
SUBORDINATION
TYING DOWN THE SUBORDINATED CREDITOR - HOW TIGHT CAN THE KNOT BE?

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Capital comes in two basic forms - debt and equity.

The Wilson Committee called to review the functioning of UK financial institutions in 1980 referred to equity as "the key resource" - the characteristics which make it the highest quality capital being that it can absorb losses while leaving a company able to trade; there is no fixed maturity; and it has no fixed servicing costs.

Without intruding too far into those aspects of subordination which are to be addressed by Don Argus, one can say, broadly speaking, that the tighter the knot the closer subordinated debt gets to equity.

Why subordinate debt?

There are many and varied reasons but they usually arise in one of two basic situations -

- where there is inter-group or proprietor indebtedness and third party debt;
- where there is "layered" third party debt.

In addition, directors are (or now should be) aware of the obligations imposed on them by the Companies Code in connection with allowing a company to continue to trade where it is not able to pay all its debts. The test is not all its current debts but all its debts, with the result that inter-group or proprietor indebtedness may require formal subordination - rather than mere informal expectation that certain indebtedness will not need to be repaid in the event of a company's deficiency in liquidation to meet the claims of unrelated creditors.

Subordination is an arrangement or a condition of things where one creditor (the subordinated creditor) of the borrower, agrees to accept limitations on the servicing and/or repayment of his debt to the advantage of another creditor.

It is to be distinguished from simple priority arrangements amongst ranking creditors.

Basically there are two levels of subordination - two threshold levels of "tightness" if you like - each capable of sustaining more or less turns of the screw depending on the requirements.

The first level - sometimes referred to as inchoate subordination - allows payment to be made on the junior debt (perhaps confirmed to interest) until a trigger event such as borrower's liquidation or the acceleration of senior debt occurs. It is appropriate to "layered debt" or situations where there are several lenders each enjoying different debt rankings as between themselves as established by contract between them.

The second level is at the group, inter-company or proprietor level where vis-a-vis the third party lender members of the group or proprietors are required to subordinate indebtedness in absolute terms, sometimes referred to as "complete subordination" - the bottom line being that in this case no payments may be made on the junior debt until the senior debt has been paid.

The Companies Code provides:

(a) that on the winding up of a company certain debts are to be paid in priority to all other unsecured debts (s.441);

(b) that except as otherwise provided by the Code all debts proved in a winding up rank equally and, if the property of the company is insufficient to meet them in full, they shall be paid proportionately (s.440); and

(c) subject to the provisions of the Code as to preferential payments, the property of a company shall on its winding up, be applied in satisfaction of its liabilities equally (s.403).

The statutory priorities must be observed but the provisions of sections 403 and 440 can be overcome through well drafted priority or subordination arrangements as outlined by Maurice Cashmere.

One matter of concern to senior debt holders is to ensure that no hurdles can be placed in their way by junior creditors when it is their wish to bring about liquidation of the borrower consequent upon a default.

This is a timing question - immediate liquidation may be the wish of senior debt - deferment and continuance in business may be the wish of the junior or subordinated debt.

How tight can the knots be?

In the case of complete subordination the answer is very tight.

The subordinated debt is forced into the position of quasi-equity.

Here it would be usual to find the subordination expressed in terms which meant that the junior creditor could not ask for, demand, sue for, take or receive from the borrower the whole or any part of the moneys owing to him nor any security therefore unless and until all senior debt had been fully paid.

An extreme form is the "perpetual subordinated debt" recently offered by a number of the London clearing banks and more recently by an Australian trading bank [see "Sterling Debt Securities in the Mid-1980's" by Robert Burgess, Journal of Business Law, 1986-July].

In the case of inchoate subordination the recent Bond Brewing Group financings offer an insight.

The financing involved three separate debt raisings all carried out simultaneously and comprising -

- a syndicated bank loan facility denominated in A$ but available in a variety of currencies and with a variety of funding options;

- an issue of zero coupon senior notes denominated in US dollars and raised in the US and Europe through US underwriters; and

- an issue of fixed rate subordinated debentures denominated in US dollars and raised in the US by US underwriters.

The zero notes were guaranteed by an L/C issues to note holders by the Banks pursuant to the Banks' facility and hence afforded "senior" status along with the Banks. The debenture holders were treated as junior debt.

Whilst the Banks initially sought security for their loans, this was unacceptable to the US underwriter for the subordinated debentures.

Apparently "layered" debt is merchantable in the US markets if established on a priority/subordination basis but not where the senior levels enjoy security on the business assets of the borrower.

The Banks as senior ranking debt sought, initially, a position where -

- no payments including interest could be made to the junior debt save on the certificate of the banks security trustee that no event of default or potential event of default had occurred; and

- junior debtholders could not oppose (nor even seek to be heard in) any application initiated by the banks to wind up the borrower.

US Counsel for the underwriters of the subordinated securities objected to these provisions on the grounds that they were not "customary" in the market that had been established in the US for such securities - generally known as "non-leveraged buy-out subordinated securities".

In particular the prohibition on payments save against the security trustee certificate was said to reverse the normal order of things and that stoppage should only occur after notification of an actual event of default or upon maturity of the senior debt by lapse of time, acceleration or otherwise.

Also it was said that purchasers of such securities would not accept provisions designed to preclude them from any form of opposition to or obstruction of a winding up application. In the form submitted by the banks this would have prevented them voicing views in opposition at a meeting convened to ascertain creditors wishes under section 431 of the Code. It also would have precluded the subordinated creditors either themselves or through their trustee initiating any form of action through the courts for example to restrain an application for winding up on any grounds.

Ultimately the underwriter for the junior debt holders was prepared to accept that position provided it was expressly recognised that the holders of junior debt would not be precluded from appearing and being heard in any court proceeding in connection with any action taken to wind up or consulting with the company as regards any position the company might take in any such action.

The US Securities Exchange Commission however took the view that such provisions, even in their amended form, would be inconsistent with the requirements of the US Trust Indenture Act [section 315(c) whereof stipulates that a (qualifying indenture) shall contain provisions requiring the indenture trustee to exercise in case of default such of the rights and powers vested in it by such indebenture and use the same degree of care and skill in their exercise as a prudent man would exercise or use under the circumstances in the conduct of his own affairs] in that it would operate to deny the trustee the ability to exercise such degree of care and skill in pressing the interests of the subordinated creditors he was required to represent.

Against the SEC's refusal to register the document in this form the Banks ultimately agreed to its removal.