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macROBERTS

Summer
2010

BANKING NEWS

ABL - FUNDING RECOVERY

We are all aware that we are now operating in strange waters when it comes to the funding of transactions. The market is very different from the one in which most of us have spent our professional careers operating and obtaining funding for transactions that would have been routine a few years ago can now sometimes seem like pot luck.

However, we believe that the current circumstances are likely to give rise to an increased use of asset based lending (ABL) in transactional funding compared to previous years.

There has of course been a push over a number of years for lenders to increase the amount of their book that is backed by assets. Over the past 10 years we have seen a substantial increase in the use of invoice financing and sale and leaseback/HP type arrangements and a compensating drop off in the more traditional overdraft arrangements. In our view, it is likely that market considerations may lead to an even greater use of such arrangements in funding acquisitions.

It is of course fairly well known that invoice financing is not suitable for use in all areas and indeed whole sectors have traditionally been considered not to be appropriate for such funding. One might expect however to see increasing innovation by funders, and sectors that may previously have been considered "off limits" may now become hunting grounds for ABLs.

Asset based lending can also be used as "top up" funding in order to get a deal over the line and can be used in conjunction with other forms of financing where the circumstances warrant it. While it may be that equity



investment will make a comeback in the short-medium term, it is probably true that over the past few years, the dearth of equity players in Scotland in the £1m - £5m market has held back opportunities and business growth. ABL has undoubtedly picked up some of the slack in that area and has been increasingly used in funding acquisitions (particularly management buy-outs).

We consider that this is likely to continue and grow given that a substantial number of the transactions that will occur over the next few years will come out of insolvencies. Whether or not one approves of pre-packs and phoenixes (and it is important to distinguish between the two), in order to maximise the return to creditors an insolvency practitioner will often have no alternative other than to sell to the incumbent management in order to achieve a sale as a going concern. Given insolvency practitioners' reluctance to warrant the quality of information that is given to purchasers (and

their funders) the involvement of management in newco will often be necessary to have any chance of satisfying funders' due diligence requirements.

It may well be therefore that ABL funded transactions out of insolvency are likely to be on the rise.

ABL in acquisition transactions requires to be carefully documented (and often the documentation has to be bespoke). For example, in debt financing, the process has to be very different if what is being funded is a business acquisition rather than a share transaction. In addition, substantial differences between Scots and English law in these matters means that specialist legal advice is always required.

At MacRoberts, we have lawyers with an in-depth understanding of the commercial requirements of asset based lenders and substantial experience in the use of such arrangements in funding transactions.

THE REMEDIES DIRECTIVE AND RISKS TO FUNDERS

Historically in PPP-type transactions, funders have taken comfort in the knowledge that once a project agreement had been entered into following a public procurement procedure, there was negligible risk that a court would call the validity of the contract itself into question, where it emerged there had been a breach of the public procurement rules: the procurement rules expressly restricting the Court's ability to grant any remedy other than damages where a contract had been entered into. That is, until now!

Along with corresponding new legislation for England & Wales, the Public Contracts and Utilities Contracts (Scotland) Amendment Regulations 2009 (amending the Public Contracts (Scotland)

Regulations 2006) came into force on 20 December 2009 and implement the EU Remedies Directive 2007/66/EC. Now under those Regulations, courts may render a signed contract prospectively ineffective in certain circumstances - meaning all future obligations unperformed at the date of the court order will be ineffective. Also, the new rules say where the Court declines to make an order for ineffectiveness it must instead order the payment of a financial penalty or contract shortening.

Clearly, the new remedies give rise to a number of risks for funders: it will no longer be possible to rely on contract signature in the same way as before, and funders would be best advised to take steps to address the consequences.

Ineffectiveness

In brief, there are three grounds for ineffectiveness:

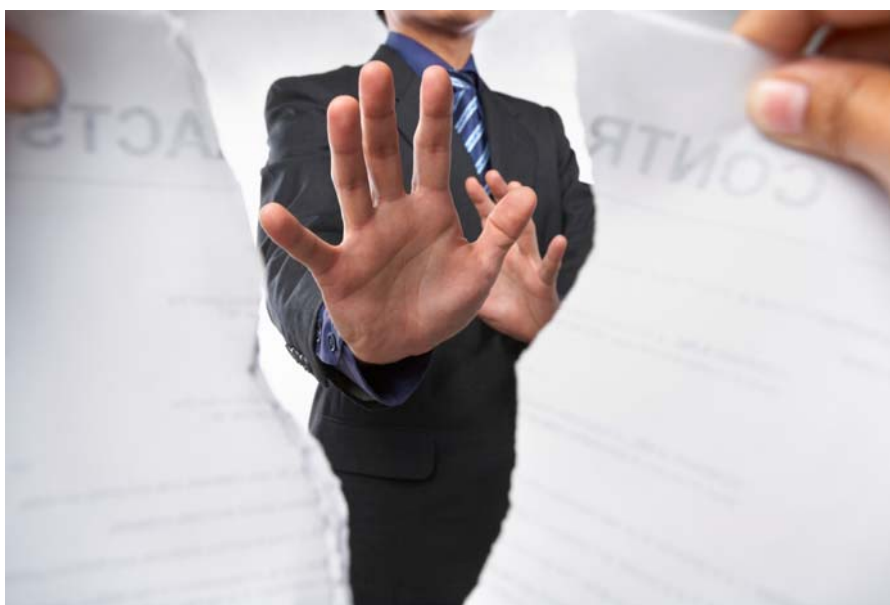
- I. Where the contract has been entered into without publication of a contract notice, where advertisement is required (unlawful direct awards);
- II. Where the contract has been entered into: (a) in breach of the review procedural rules (outlined below) and that breach deprives a bidder of pursuing pre-contractual remedies, and (b) in breach of the substantive procedural rules (e.g.

discriminatory award criteria) where that breach affected the chances of the aggrieved bidder winning the contract; or

- III. Where there has been a breach of the requirements relating to a Framework Agreement or Dynamic Purchasing System (not likely to be relevant to funders of PPP-type Projects).

Minimising the Risks

As a prime concern, funders will wish to ensure that sufficient protective measures are put in place to mitigate as far as possible the risk that a contract will be rendered ineffective (or shortened).



What steps should be taken?

Ground I - Direct Awards

An authority will rarely enter into a PPP-type contract without prior advertisement. However, funders should ensure an authority has complied with Europe-wide (OJEU) advertising requirements where required, and have regard to circumstances where an authority wishes to change contract terms significantly during or after the procurement (after a preferred bidder has been selected or contract award).

For example, funders might consider conducting a compliance check of the authority's advertising procedures or require the rules on voluntary transparency to be used (where possible).

Ground II - Two Strikes

The second ground for ineffectiveness is more complex than the first, involving a breach of the notification requirements (i.e. a breach of the requirement to issue an Award Letter notifying all bidders and

candidates of an award decision and allowing a period of at least 10 or 15 days to expire before entering into the contract), and a breach of the substantive rules.

To mitigate the risk of potential challenge, funders may also wish to check the compliance of the Award Letters and ensure the authority advises them of any requests for further information or letters before action which may indicate a rival bidder intends to raise a challenge.

Pre-Agreed Terms

More generally, parties to a contract may also agree contractual provisions governing mutual rights and obligations in the event an Order for Ineffectiveness is granted.

The Office of Government Commerce (OGC) has released guidance comparing pre-agreed terms with 'relevant discharge terms' provided for by the Local Government (Contracts) Act 1997 and states a separate collateral contract could provide for "what ineffectiveness will mean, how they will exit the contract, who owes what to whom etc", provided those terms are not incompatible with the core requirements of ineffectiveness.

A degree of caution is required however in relying on pre-agreed terms, because the Regulations do not expressly provide for their use, nor does the Guidance guide the courts as to how such terms or indemnities should be dealt with in a procurement context.

Dealing with the Impacts

Whilst their full range and depth of impact remains to be seen, the importance of the new remedies of contract ineffectiveness or shortening is hard to over-state. Ultimately, responsibility for fully understanding and adhering to the procurement rules will lie with the public sector: there will never be room for successful challenge to a fully compliant procurement.

However, funders cannot generally expect to know whether or not an authority has breached the procurement rules, so it may now be time to review current practices to ensure as far as appropriate that a public contract has been procured in compliance with the rules, and protect against contract ineffectiveness and shortening where that is not the case.

GUARANTEE UPDATE - NON COMPETITION CLAUSES



On 13 May 2010, the Court of Appeal in *Cattles Plc v Welcome Financial Services Ltd & Ors* [2010] CA (Civ Div), upheld the previous ruling in this case. Although the case is also of interest in relation to the application of the English common law equitable rule derived from *Cherry v Boulton* (1839) 4 My & Cr 442 case (regarding the right of quasi retainer), this article will focus on the court's contractual interpretation of the non competition clause itself.

The case concerned a claim brought by Cattles Plc ("Cattles") in order to determine various issues relating to debts it owed to different classes of creditors as part of consideration during a standstill period of its options to avoid insolvent liquidation. Cattles' principal assets were the amounts receivable by it from its trading subsidiaries, of which the largest amount was payable by Welcome Financial Services Ltd ("Welcome").

Cattles' financing liabilities included a number of credit facilities between Cattles as borrower and The Royal Bank of Scotland plc ("the Bank") as lender. The Bank had the benefit of a group-cross guarantee by which Cattles, Welcome and other subsidiaries had each guaranteed the payment of all obligations owed by the others to the Bank. Cattles had also issued bonds which were not guaranteed.

The Bank's argument was that the terms of its facilities and cross-guarantee meant that Cattles was prevented from recovering its intercompany debts from Welcome and other group companies until each had satisfied their obligations under the guarantee in full. If this were the case this would mean that the assets available to the bondholders would be substantially depleted.

The case therefore centred on the terms of the relevant non competition clause (in particular Clause 6.2) of the guarantee which provided that:

"6. *Until all claims of the Bank in respect of all of the Obligations of each Debtor have been discharged in full:*

6.1 *no Guarantor shall be entitled to participate in any security held by the Bank or money received by the Bank in respect of any Debtor's Obligations;*

6.2 *no Guarantor shall in competition with or in priority to the Bank make any claim against any Debtor or any co-guarantor or their respective estates nor make any claim in the insolvency of any Debtor or any co-guarantor nor take or enforce any security from or against any Debtor or any co-guarantor; and*

6.3 *any payment received by a Guarantor in breach of clause 6.2 and any security taken by a Guarantor from any Debtor or any co-guarantor shall be held in trust for the Bank as security for the liability of the Guarantors to the Bank under this deed."*

As this was a cross guarantee, the terms "Guarantor" and "Debtor" each included all group companies involved in the financing.

Cattles had submitted that this drafting terminology led to the conclusion that Clause 6.2 restricted only the making of any claim which a guarantor had arising out of its capacity as guarantor (such as a claim for counter-indemnity by the principal debtor or contribution from a co-guarantor). The Bank had argued that this clause operated as a contractual prohibition on the claiming of **any** inter-company debt due between the companies party to it until all the guaranteed obligations to the Bank had been paid.

In upholding the original decision (supporting the Bank's position) the reasoning of the Court included the

following which is worthy of note:

1. the purpose of such a clause is to preserve the Bank's claims and to prevent same from being diluted in event of the insolvency of one or more of those liable to it and it would not be "commercially rational" or "objective" to limit the ambit of the restrictions in Clause to claims by the relevant party as guarantor;
2. use of the defined terms "Guarantor" and "Debtor" did not mean that only the relevant person's claims in such capacity were restricted by this Clause and did not serve to limit the operation of the words "any claim" and "in competition with or in priority to the Bank" in Clause 6.2;
3. the use of the words "any claim" in this context should be interpreted to mean any claim which the relevant party had and not just those in its capacity as a guarantor;
4. that the words "in competition with" did not mean competition only between creditors and guarantors in respect of the same debt but also encapsulated competition between competing creditors for different debts owed by a common debtor; and
5. that the phrase "under this deed" had been used elsewhere in the guarantee but not in the relevant clause and as such a clear intention of the parties could be inferred that claims should not be limited in such a way.

This case shows that the Court is willing to look at the purpose of the relevant clause in reaching a decision but that the specific drafting used will also play a big part in the determination of a particular issue such as this. On that basis, borrowers, guarantors and lenders will require to be well advised as to the exact wording used in such clauses, and in guarantees generally, in order to achieve the desired outcome.

While the above case relates to English law guarantees, it is likely that such a decision of the Court of Appeal, while not binding, would be considered persuasive in Scotland and that Scottish courts would consider this case in deciding similar issues.

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NATIONAL HOUSING TRUST

The Scottish Government and the Scottish Futures Trust (SFT) are working with a number of local authorities with the aim of pioneering the National Housing Trust.

The scheme aims to involve the public and private sectors working together to provide a programme of local projects to provide medium-term affordable housing for mid-market rent, in areas where there is a shortage of affordable housing. It is also hoped that the scheme will stimulate the housing market and provide an incentive for developers to re-commence building on sites where the economic climate has led to stalled developments. Around 1,000- 2,000 homes are forecast to be made available through the scheme for 5/10 years, although the final number, and location, of homes will depend on the results of an open procurement process to ensure quality, fitness for purpose and value for money.

How will it work?

Public funding would be secured through the Public Works Loan Board (PWLB) and utilise the prudential borrowing powers of participating local authorities, which would be guaranteed by the Scottish Government. Local Authorities would pay developers 65% of the market value of any completed housing (an effective guarantee of 2/3 of developers income) and the properties would be owned by separate LLPs. The remaining private funding is anticipated to be split 5% loan note and 30% equity investment. Developers would be expected to secure

funding for the completion of the properties, on the basis of an agreed Authority take-out, and residual value of the properties.

The developer and the Authority would set up an LLP to rent out the properties for up to 10 years, at the end of which period the properties will be sold on. Rent money during the lease period would be used to pay maintenance costs and interest on the funding. The money from the sale at the end of the period will go firstly towards paying off the Authority loan, secondly to the developer to pay the remaining 35% of the market value, whilst the remainder will be profit to the developer. This profit, however, will be capped, with any excess going back into the Authority's housing budget.

How will it be taken forward?

16 councils have, so far, confirmed that they are interested in the scheme, whilst a few others remain in discussion. The SFT has held a bidders day and published a Prior Information Notice (PIN) (<http://ted.europa.eu/udl?uri=TED:NOTICE:93497-2010:TEXT:EN:HTML>) in the Official Journal of the European Union (OJEU) in advance of the formal procurement process, in order to allow for feedback on the proposals from builders, banks and facilities management agents. It is intended that each Authority will seek to select a framework of bidders, and, with that framework, undertake call-off competitions to deliver the most suitable and best value properties for the scheme.



Will it work?

There has been significant interest from a number of parties in the scheme. How bidders will actually be selected (how do you fairly compare one local developer with one property or development to a national developer with numerous developments?) has yet to be determined and could raise some difficult issues under public procurement law. Also, will developers be persuaded to commit to a scheme where they receive only a part return on profit, when they may view that a recovering market will give them better opportunities? And, will funders actually wish to back property development, based on residual value return, bearing in mind the issues they have faced recently?

There is no doubt that there is a shortage of mid-market rent properties. But, there is also a shortage of other housing, particularly social housing. Is this the best use of public funds, especially in the current environment? That is a political decision, but it may be a welcome move for all parties; to deliver much needed housing, promote house building activity, and stimulate lending activity.

DEALS ROUND-UP

- Advising on the Scots law aspects of the putting in place of new banking facilities for **Johnston Press PLC** and its group companies, which was announced to the London Stock Exchange on 28 August 2009.
- Acting for **Clydesdale Bank** in amending facilities of over £140m provided by the Bank to Robert Wiseman Dairies.
- We advised **Morris and Spottiswood Ltd** in relation to a building contract for the re-fit of Tay House, Bath Street, Glasgow.
- Acting for **Albion Automotive** in relation to a refinancing being carried out by its parent company American Axle and Manufacturing, Inc. with JPMorgan Chase Bank, N.A.
- Acting for **HSBC Bank** in connection with its provision of a stock facility in relation to a whisky purchase.
- Acting for **HSBC Bank** in relation to facilities provided to assist with an employee buy-out.
- Acting for a club of four Banks comprising **Lloyds, The Royal Bank of Scotland, HSBC and Clydesdale** in relation to facilities provided to Wm Grant and Sons Distillers Ltd to fund the purchase of certain drinks brands from Magners owner C&C Group plc.
- Acting for **Barclays** in relation to its provision of facilities of circa £13m to the 2009/2010 Regent Capital St Andrew House Syndicate. The Syndicate purchased St Andrew House on Sauchiehall Street in Glasgow, which will be redeveloped.
- Advising Australian company **Ampcontrol Pty Ltd** in relation to the Scottish aspects of a refinance of its facilities with Westpac Banking Corporation.
- Acted for **Hamilton Capital Partners** in relation to the purchase of MacFarlane House in Dennistoun by HCP 1 (Dennistoun) LLP. The purchase was funded by a circa £4m facility provided by Barclays Bank plc.
- Acting for **The Royal Bank of Scotland** in relation to funding provided by it for the management buy-out of Aberdeen based Nu-Style Products Ltd.

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