TRAVERS SMITH

Finance Monthly

March 2012

Welcome to the monthly finance bulletin from our banking and corporate recovery department. This issue contains our usual overview of some recent market developments and trends in the finance sector; and includes a spotlight on Schemes of Arrangement in an Insolvency context. Please get in touch if it raises any issues that you would like to discuss.

Jeremy Walsh, Head of Banking and Corporate Recovery Department

Interest Rate Swaps and Financial Mis-selling

Banks and financial institutions emerging from the damaging rash of claims based on the mis-selling of payment protection insurance are facing a similar onslaught from claims management companies and solicitors with respect of the alleged mis-sale of interest rate swaps. The Treasury has begun information gathering to determine the scale of the potential problem and Parliamentary questions were tabled in March. There is the prospect of a Treasury investigation, possible FSA action and energetic marshalling by active claim managers representing small and medium size businesses.

The key elements of the claims are likely to concentrate on the fact that as the financial crisis approached, interest rates fell to historically low levels and customers were locked into much higher rates with a disconnect between their loan exposure (which they wanted to reduce) and their swap exposure (which could not be reduced without penalty). Customers are expected to argue that the implications of this were not adequately explained to them and that they were therefore denied the ability to make an informed choice. The success or failure of such claims is likely to influenced by whether the interest rate swap was an "execution only" transaction or an "advisory" transaction; whether it was required or recommended by the financial institution and, if so, whether that institution followed the FSA Code of Business Rules so that reasonable steps were taken to ensure that any recommendation given was suitable; that the customer had the necessary experience and knowledge to understand the risks involved in the swaps; and that the customer was capable of making an informed investment decision. The sophistication of the customer is therefore likely to be relevant and accounts for the focus of claim management companies on small and medium sized businesses.

UK competition law reform

The government recently announced changes to the UK's competition regime. Please *click here* for a summary of the key points for businesses.

HMRC Consultation; Tax Treatment of Interest

On March 27, HMRC issued a consultation document with respect to the tax treatment of interest and interest-like returns and the deduction of tax at source from such amounts. Proposals, which invite comment by 22 June 2012, include (a) a requirement to withhold tax from interest payments and loans with a duration of less than one year (which are currently exempt under the long-standing "yearly interest" rule) and (b) the removal of the current concession enabling interest to be paid gross under quoted Eurobonds, where those payments are made under listed Eurobonds issued by a company to other group companies and where there is no substantial trading in the bonds. The conversion of inter-company debt into quoted Eurobonds enables a company to make gross payments of interest out of the UK to a fellow group company, where otherwise deduction of tax would be required. The removal of the exemption from listed Eurobonds where there is no substantial or regular trading will have potential implications for the structuring of intra group debt. Please *click here* for a note from our Tax department on the consultation document.

Debt Buybacks: Retrospective Law Change

The release by a creditor of part of a debtor's obligations to repay a debt results in a taxable charge on the debtor. In addition, if a debtor buys back its debt at least than par, the debtor will realise a profit and be taxed accordingly.

Spotlight on… Schemes of Arrangement in an Insolvency context

Over the last year or so, English schemes of arrangement have been frequently exploited by companies registered in EU member states and with their centre of main interests outside the UK which have sought to restructure their debts in the absence of analogous solutions in their home states.

A scheme of arrangement is simply a tool that can be used in an insolvency context to restructure a company's debts and as an alternative to liquidation proceedings in order to provide a better return to creditors. An English Scheme of Arrangement can be sanctioned by an English court for a foreign company only if it can be wound up under the Insolvency Act 1986.

Fortunately, a foreign company carrying on business in the UK or having a sufficiently close connection to England (assets within the jurisdiction will suffice) will frequently satisfy this test.

A number of English court decisions have asserted that the Insolvency Act 1986 test merely determines whether the English courts have the discretion to wind up – whether they have jurisdiction to do so is another matter and there is recognised English judicial authority to the effect that neither the EC Insolvency Regulation or the EC Judgments Regulation precludes the jurisdiction of the English courts to convene scheme meetings and sanction schemes of arrangement with respect to companies with their seat and centre of main interest in another Member State. Whether the English courts will accept jurisdiction is determined by jurisdictional connection (consistently held to be satisfied where finance documents are governed by English law and subject to the exclusive jurisdiction of the English courts) and whether that the scheme will be legally effective in the company's domestic jurisdiction where its assets or creditors are located.

Proponents of schemes have argued with some force that the EC Judgment Regulations, the UNCITRAL Model Law on Insolvency and Rove I (No. 593/2008) all support this conclusion, as do German court judgments recognising an English scheme as an insolvency proceeding analogous to US Chapter 11. An alternative solution to the recognition problem is to secure the agreement of creditors in advance to be bound by the restructuring and the scheme.

Avoidance schemes using a company connected with the debtor to buy the debt and then release the debt thus avoiding a tax charge by taking advantage of the connected company rules were closed off by legislation in 2005 which was subsequently tightened in 2009. The latest schemes, which are to be addressed by new legislation, involve debt bought by an unconnected company, and then released after the purchasing company becomes connected with the debtor. The new legislation, effective from 27 February 2012 renders such schemes ineffective with retrospective effect from 1 December 2011.

In the courts

Re Lehman Brothers International (Europe) (in administration) [2012] UKSC 6 Supreme Court

On 29 February, the Supreme Court handed down its judgment in relation to the Lehman's 'client money application'. The decision means that all clients whose money was held by LBIE will now be entitled to share in the distribution of the client money pool (around $2bn), and not just those clients whose money was segregated from LBIE's own assets.

The Supreme Court considered three issues concerning the FSA provisions relating to client money, set out in chapter 7 of the Clients' Assets Sourcebook ("**CASS 7**"):-

(i) when does the statutory trust created by CASS 7.7 arise?

(ii) do the primary pooling arrangements apply to client money held in house accounts?

(iii) is participation in the client money pool dependant on actual segregation of client money?

The Court held:

(i) that a statutory trust over client monies was created from the time of receipt by a firm, not upon the segregation of client monies;

(ii) that the primary pooling arrangements applied to all client monies held by a firm. Client monies held in Lehman's house accounts (and not segregated) were therefore deemed to form part of the client money pool and available for distribution to clients on insolvency; and

(iii) that a claimant with a contractual claim for client money has the right to share in the client money pool based on the amount which ought to have been segregated at the date of the primary pooling event (the date administrators were appointed in respect of LBIE), not the amount of client money which was actually segregated on that date.

The implications of this decision are far reaching from a regulatory and insolvency perspective. The number of clients sharing in the $2bn client money pool will significantly increase because the Supreme Court adopted the interpretation of CASS 7 which afforded a high degree of protection for all clients who have client money with a firm. The distribution of client monies will be further delayed as the administrators of LBIE are now obliged to trace client monies in, or which passed through, its house accounts.

The decision will be applicable to other financial services firm failures, notably MF Global UK. It is also likely that the FSA will call for a further review of the CASS rules to ensure greater protection of client money and the process of distribution.

Recent transactions

We have recently advised:

- RBS on its £50m revolving facility to F&C Private Equity Trust plc
- a syndicate of lenders (led by NATIXIS) on the refinancing of a 5 star hotel in Mayfair.
- CIMB Bank on its funding for the development and acquisition of a high end mixed use residential development in W1.
- Advising Phoenix Equity Partners in connection with the funding of the acquisition of Gall Thomson Environmental Limited.

Department News

We are delighted to welcome associate Kate Donovan to the department. Kate joins us from Dickinson Dees and specialises in Corporate Recovery.

Kate Dickens has been seconded to the Public Finance and Infrastructure team at Santander.

Practice Development

Matthew Ayre, Paul Lyons, Charlie Bischoff and Danny Peel presented the third in a series of seminars to the leverage finance origination and portfolio teams from Lloyds Banking Group, entitled "Hot topics and solutions in a challenging environment – a sponsor's perspective".

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