

Welcome to the Autumn 2010 edition of Finance Focus, the regular update from Thomas Cooper's Finance Group, in which you can review the latest legal developments in your area of finance and keep up-to-date with our news and forthcoming events.

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Basel III

The increased cost implications for finance documents are a concern with the strengthened capital requirements announced by the Basel Committee on Banking Supervision (BCBS), which are to be implemented in the EU by a package of amendments to the Capital Requirements Directive referred to as CRD 4.

On 12 September 2010, a BCBS press release announced that the Group of Central Bank Governors and Heads of Supervision, the oversight body of the BCBS, had agreed a substantial strengthening of capital requirements, as part of Basel III. These Basel III proposals will be presented at the November 2010 G20 leaders' summit. The capital requirements will be phased in from 1 January 2013 to 1 January 2019.

The new capital requirements are summarized as follows:

- **Quality of capital.** The minimum capital ratio for common equity (as the core element of Tier 1 capital) will be raised from the current level of 2% to 4.5%. The overall ratio for Tier 1 capital will increase from 4% to 6%
- **Capital conservation buffer.** The capital conservation buffer above the regulatory minimum requirement will be set at 2.5%. It can be met with common equity, after the application of deductions. Its purpose is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress.
- **Countercyclical buffer.** A countercyclical buffer with a range of 0 to 2.5% of common equity or other fully loss-absorbing capital will be implemented according to national circumstances, when there is excess credit growth resulting in a system-wide build up of risk in that country.
- **Leverage ratio.** A leverage ratio will also be introduced, which will supplement the risk-based measures. It was agreed to implement a minimum Tier 1 leverage ratio of 3% and to adjust this proposed ratio, if necessary, in the first half of 2017.

The draft CRD4 legislation had been expected in December 2010, but the European Commission's intention now is to publish it in the first quarter of 2011 after the Basel III proposals have been presented at the November 2010 G20 leaders' summit. [Impact on finance documents](#)

One of the main implications of Basel III and CRD 4 for finance transactions are potential increased costs to lenders. It is possible that a lender might be able to pass these increased costs on to a borrower under the increased costs clause of its facility agreement, depending on how that clause is drafted.

Typically, under an increased costs clause, a borrower must indemnify a lender for costs it suffers as a result of a change of law or regulation (or its interpretation, application or administration). At the time that the scope of the rule changes under Basel II became clear, borrowers argued that banks' future regulatory capital costs should be carved out from the increased costs clause as they could be calculated in advance. Borrowers argued that even though the facility might be more expensive, borrowers would benefit from the total cost of the facility being transparent from the outset. In recognition of this issue, the Loan Market Association's facility agreements provide optional wording for such a carve-out of increased costs arising (if any) arising from the implementation of Basel III and CRD 4.

OUR TEAM



[Grant Eldred](#)
020 7390 2210



[Kelly Vouvousiras](#)
+30 210 361 4840



[Kate Harrison](#)
020 7390 2238



[Mark Glenister](#)
020 7390 2281



[Stephen Swabey](#)
020 7390 2234

EU financial supervisory framework

On 22 September 2010, the European Parliament published a press release announcing that it had voted to approve legislation reforming the EU financial supervisory framework. It has also published FAQs on the reforms.

The new framework will consist of a European Systemic Risk Board and three European Supervision Authorities (that is, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA)). EBA, ESMA and EIOPA will replace the existing Level 3 committees, the Committee of European Banking Supervisors (CEBS), Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), with effect from 1 January 2011.

Liquidated Damages Clause in Shipbuilding Contract

In *Azimut-Benetti Spa (Benetti Division) v Healey* [2010] EWHC 2234 (Comm), the High Court has granted summary judgment in favour of a shipbuilder seeking to enforce a liquidated damages clause. This decision shows the courts' willingness to uphold a liquidated damages clause in a commercial agreement negotiated by lawyers between parties of equal bargaining power. It is also an example of the courts explicitly deciding a penalty clause issue by reference to the "commercial justification test", under which a liquidated damages clause may be upheld, not as a genuine pre-estimate of loss, but on other commercial grounds, provided always that its principal purpose is not to deter breach of contract.

The case is also of interest because the court considered, obiter, the effectiveness of a guarantee that purports to guarantee payment under an unenforceable penalty clause.

Background

An Isle of Man special purpose company (buyer) engaged a luxury yacht builder to build a yacht for the benefit of Mr. Healey (defendant). Each side employed lawyers to draw up the contract. The buyer was at all times wholly owned by the defendant, who entered into a separate guarantee under which he guaranteed the buyer's obligations under the contract.

The buyer defaulted on an installment, and the builder terminated the contract and sought to exercise its rights against the buyer under clause 16.3 of the contract, which provided that, in the event of a late payment, the builder could end the contract and retain (or recover) 20% of the contract price by way of liquidated damages. On non-payment, the builder applied for summary judgment against the defendant. The defendant resisted the application, arguing that the relevant clause was a penalty, not a genuine pre-estimate of loss (in which case there would be no liability on which the guarantee could fasten). The defendant submitted that, because it had raised the penalty argument, the court was required to form a view on whether 20% was a genuine pre-estimate of loss, which it would only be able to do after hearing detailed evidence from both sides at full trial.

Decision - the liquidated damages clause

The judge held it was not even arguable that the clause was a penalty and gave summary judgment for the amount claimed.

The judge considered whether there was a clear commercial and compensatory justification for the clause. The judge found the evidence showed that there was a clear commercial justification for the clause, namely the buyer's interest in avoiding the delay that might be involved in recovery based on actual loss, and getting an immediate refund of any excess payments. In reaching this conclusion, the judge reviewed evidence of the negotiations. Although not admissible to help interpret the contract, this evidence was admissible to show the parties' reasons for agreeing to the liquidated damages clause. The judge also followed the principle that, at least in connection with commercial contracts, great caution should be exercised before striking down a clause as penal.

Decision - the guarantee

The judge also considered, in a non-binding part of the judgment, whether a clause in the guarantee saying the defendant's liability was not to be "impaired, diminished, discharged or released by reason or in consequence of ... the irregularity, illegality, unenforceability or invalidity in whole or in part of the Yacht Construction Contract" would have been effective to make the defendant liable for the sums to be paid under clause 16.3, even if clause 16.3 was a penalty clause. The judge said that the same public policy which makes a penalty clause invalid would prevent its indirect enforcement through the guarantee. The guarantee applied to the buyer's obligations, and if clause 16.3 had been a penalty, no obligation would have arisen under it.



Charles Williams
020 7390 2227



Nicholas Green
020 7390 2222



Tim Goode
020 7390 2204



Simon Murfitt
020 7390 2321



Peter Gordon
020 7390 2235



Yuliya Dzymba
020 7390 2296

Commentary

If putting forward a liquidated damages clause providers of finance should:

- Make sure the figure proposed can be justified as a genuine pre-estimate of loss. This is still the safest way to justify the clause. If that is not possible, other commercial justifications may be sufficient, but this is not yet beyond challenge.
- Document the justifications, perhaps in the recitals to the agreement or, failing that, in written negotiations (since these will be admissible in a dispute over the liquidated damages clause). For the same reason, keep a note of verbal negotiations about the clause.
- A bare recital in the clause, or in correspondence, that the clause is a genuine pre-estimate of loss, will not help as much as a reasoned explanation for the clause.
- Consider whether it is possible to include an alternative provision, as the builder did.

If litigating a liquidated damages clause, note that:

- A mere assertion that a clause is a penalty clause will not automatically justify a full trial.
- Evidence of negotiations in respect of the clause will be admissible to show the parties' reasons for agreeing to the liquidated damages clause.

Statutory Demands must contain correct creditor's details

In *Agilo Ltd v William Henry* [2010] EWHC 2717 (Ch), the High Court considered whether putting the wrong creditor's name on a statutory demand against an individual debtor justified setting aside the statutory demand under rule 6.5(4) of the Insolvency Rules 1986.

Background

The Insolvency Act 1986 deems an individual insolvent if a creditor serves the individual with a statutory demand for an amount in excess of £750 and the individual, within three weeks of being served with the demand fails to settle the demand to the creditor's satisfaction; and does not make a successful application to set aside the statutory demand.

For the purposes of a statutory demand, a creditor is anyone to whom the debtor owes a "bankruptcy debt". A bankruptcy debt is a debt that would entitle the creditor to receive a share of the debtor's assets in a bankruptcy.

A debtor can apply to court for an order setting aside a statutory demand, if they can show that the demand is defective in some respect.

A court must set aside a statutory demand issued in the name of someone to whom an individual does not, in fact, owe money. In such circumstances, the court must set aside the statutory demand even if:

- The demand complies with the requirements of the Insolvency Act 1986 and the Insolvency Rules 1986 in all other respects.
- The demand refers to the true creditor in the body of the demand and clearly identifies the relevant debt.
- The debtor appears to owe the sums in question to the true creditor.

By extension, a court should usually set aside a statutory demand where the debtor raises an arguable case that a demand was issued in the name of someone who is not a creditor of the debtor.

Comment

The High Court's judgment illustrates the importance of making sure that a statutory demand is accurate before serving it on the debtor. Even though the defect in the demand was, commercially speaking, minor, it was sufficient to allow the debtor to escape making payment under a guarantee in the short term and will no doubt increase the costs incurred by the creditor in pursuing the debt.

Distinction between subrogation and marshalling

The High Court has held that the doctrine of marshalling of securities is distinct from equitable subrogation. The court held that although the effect of marshalling was to subrogate an unsatisfied junior creditor to a satisfied senior creditor's security, marshalling was not a kind of subrogation. It was therefore, if marshalling applied, not necessary for the junior creditor to prove (as would be the case with subrogation) that it did not receive the security for which it had bargained.

Marshalling

Marshalling is an equitable remedy available to a creditor (C) in circumstances where there are two creditors of the same debtor, each owed a different debt. Another creditor, (A), and C have both taken security over some of the debtor's assets (Assets 1). A has also taken security over some of the debtor's other assets, over which B has not taken security (Assets 2). A has enforced its security over Assets 1 but not over Assets 2. In these circumstances, C is entitled to use Assets 2 to repay any of the secured debts owed to it that cannot be repaid out of Assets 1 because of A's actions.

Subrogation

One kind of subrogation is an equitable remedy to reverse or prevent unjust enrichment which is not based on any agreement or common intention of the party enriched and the party deprived. A classic example of this involves a lender that expected to receive security claiming subrogation to another party's security if it does not get that security. However, a lender cannot claim subrogation if it obtains all the security which it bargained for, or where it has specifically bargained on the basis that it would receive no security. Subrogation cannot be invoked so as to put the lender in a better position than that in which it would have been if it had obtained all the rights for which it bargained.

Comment

The court's clarification of the distinction between the doctrines of marshalling and subrogation is helpful. In circumstances when marshalling is available, a junior creditor does not have to fulfill any additional conditions that attach to being entitled to subrogation (such as proving that it did not receive the security for which it had bargained). This seems to be the case even when the effect of applying the doctrine of marshalling is that the unsatisfied junior creditor is subrogated to the satisfied senior creditor's security.

Also of interest, is that a secured party can contractually exclude or vary its right of marshalling of securities. A clause excluding a junior or subordinated creditor's right of marshalling is sometimes included in the intercreditor deed. It seems that such a clause would be upheld by the courts.

Performance bonds distinguished from guarantees

The High Court has set out the distinction between a performance bond and commonly used guarantee and indemnity language (*Vossloh Aktiengesellschaft v Alpha Trains (UK) Ltd.* [2010] EWHC 2443 (Ch) (05 October 2010)).

Performance bond

A performance bond (also called a demand bond or demand guarantee) is a particularly stringent contract of indemnity. It is a contractual undertaking by a person, usually a bank, to pay a specified amount of money to a third party on the occurrence of a stated event. Sometimes, the wording of the performance bond means it is payable on demand by the beneficiary, even if the underlying obligor is not in any way in default or even if the person demanding payment is himself in default.

Guarantee

A guarantee is a promise to the beneficiary of a guarantee to ensure that a third party fulfils its payment (and sometimes performance) obligations and/or a promise to fulfill those obligations if that third party fails to do so. It is a contractual agreement that creates a secondary obligation to support a primary obligation of one party to another. A guarantee is a secondary obligation, contingent on the borrower's or another person's primary obligation. The guarantor's obligations will therefore never be greater than those of the obligor under the primary agreement. If there is any uncertainty in how to interpret a guarantee, the courts will presume that the interpretation less onerous for the guarantor is correct.

The question of whether a contract of surety is a guarantee (secondary obligation) or an indemnity (primary obligation) is an important one that has always been the subject of debate and litigation. Recently, however, the standard practice of drafting guarantees to incorporate indemnities, conclusive evidence clauses (allowing the beneficiary to certify the amount owing under the guarantee) and wording to make the obligation payable on demand has led to a number of cases (of which this is one) in which the court is asked to carry out a detailed clause-by-clause construction of a guarantee and indemnity in order to decide whether it is in fact a guarantee or a performance bond.

Decision

The court held that the guarantee was not a performance bond.

A strong presumption exists that a performance bond is a specific banking instrument issued by a bank and that where the words "on demand" are encountered outside this context, they should not be treated as creating a performance bond. This presumption was not rebutted in this case for several reasons. The most important of which was that clause 2 of the guarantee (setting out the obligations undertaken by the guarantor) was drafted on the premise that a failure of performance by an underlying obligor has occurred. This meant that the guarantor's obligations were secondary obligations supported by some primary obligations that only came into effect once the secondary obligation had been triggered. None of the other clauses in the document altered this basic conclusion about the nature of the document. The waiver of defenses clause explicitly required the guarantor to comply with clause 2.1 before raising any defenses to payment, and this link was held by the court to preserve the co-extensiveness of the guarantor's obligations because it meant that there had to be a breach on the part of the underlying obligor before any payment would be made. The conclusive evidence clause was held to apply only to the amount due under the guarantee and not to the question of whether liability had arisen under the guarantee.

The conclusion was supported by the wider context in which the guarantee was given, which indicated that it was intended to be a guarantee. The guarantee was unlimited in amount and duration and multiple demands could be made under it. The term defining a beneficiary under the guarantee was drafted very widely which meant that a demand under the guarantee could come from a wide range of persons and the benefit of the guarantee was assignable to any person.

Comment

This case provides a very clear statement of the existing law on the distinctions between a performance bond and guarantee supported by indemnities. In light of it, beneficiaries seeking to create a primary obligation payable on demand (irrespective of whether the primary obligor is liable or not) should consider using a document explicitly drafted to create an on demand performance bond.

Thomas Cooper News

New Joiner. We are pleased to announce that Valia Babis has joined the Finance Group. Valia joined us in September 2010 and will be assisting [Kelly Vouvousiras](#), head of the Finance Group in our Athens office. Valia holds first class degrees from the University of Cambridge (LL.M. in commercial law) and the University of Athens (Law). She is fluent in English, Greek, French and German.

Employment practice. We have now extended our services in the [employment](#) sector as we have over the last 18 months been taking on increased instructions in this practice area. The employment group members are [Tim Goode](#), [Grant Eldred](#) and [Peter Gordon](#). You can contact any member of the team by using the following email format: firstname.lastname@thomascooperlaw.com.

FEEDBACK

Thank you for your comments on the Summer 2010 edition of Finance Focus. We hope that you have found this edition equally informative and useful. If you have any comments, requests for topics to be covered in the next edition or would like us to add colleagues to our circulation list, please e-mail financegroup@thomascooperlaw.com

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