INTRODUCTION

By MARTIN O'DONOVAN
ACT Technical Officer

Welcome to the first-ever Technical Update section, which will bring will bring you news of the latest legal, accounting and regulatory developments that may affect your treasury operations. This section will follow very much in a similar vein to the Hotline pages of previous issues and will include commentary on input by the Association of Corporate Treasurers (ACT) into the processes of these developments.

Additionally, every month we will explore a particular subject in a little more depth. This month, starting on page 41, we look at the Loan Market Association's (LMA) new loan agreement.

If there is a subject you feel we should cover – whether it be mathematical, accounting related, market-driven or legal – please do not hesitate to send your thoughts to technical@treasurers.co.uk. ■

ACT guide to LMA loan documentation

The ACT has announced the publication of a Guide to the LMA Loan Agreement, which has been prepared by Slaughter and May. The guide, which is freely available on the ACT website, has just been updated to cover the recent revisions to the LMA Loan Agreement.

The LMA agreement, which has the conceptual support of the British Bankers Association and the ACT, aims to achieve a fair balance between borrower and lender, with terms broadly appropriate for an A-rated borrower. It is expected the standard agreement will need to be tailored to suit individual deals on a case-by-case basis. Many companies may be able to negotiate improvements. The ACT contributed to the drafting of the investment grade loan agreement but not the non-investment grade documents.

The guide is explained fully on page 41. It provides a practical explanation on each clause in the loan agreement and points out what features might be regarded as favourable to the lenders; what alternatives more suited to the borrower are available; and what arguments are typically advanced by each side in support of their respective objectives.

Even if a borrower is not using the LMA Agreement, this guide gives invaluable free advice on the detail of what to look out for in a loan agreement and what possibilities can be negotiated for.

The ACT website now also includes advice from the ACT Technical Department on approaching negotiation of new bank loan documentation by a company. The *ACT Guide to the LMA Agreement* is available on the ACT website at **www.treasurers.org**.

Slaughter and May advised the ACT on the LMA Loan Agreement and preparing the guide on a *pro bono* basis. ■

Resist market disruption

At the end of last year, the Financial Markets Law Committee recommended that parties assess whether contracts that are used in the wholesale financial markets can withstand major operational disruption.

This was its preferred approach, rather than recommending any special emergency powers to cater for the effects of operational disruption on the terms of contracts.

Various questions to consider include:

- Should the performance obligations adjust in the event of major disruption and allowances be made for any consequences of non-performance, such as non-payment arising from this cause?
- Does the contract cater for interference with the rate setting mechanisms and the business day concept?
- How will disruption feed through to grace periods, defaults, terminations and other remedies, and in particular through to cross defaults in other agreements?

A contract checklist is available at **www.fmlc.org/papers/eplchecklist.pdf**.

The ACT is carrying out an exercise of this sort with the Loan Market Association (LMA) in relation to its standard Loan Facility Agreement, which was created with input from the ACT. ■

Website updated

The tripartite financial authorities (the Bank of England, the FSA and HM Treasury) have redeveloped the financial sector continuity website **www.financialsectorcontinuity.gov.uk**.

The site gives advice on the role of various authorities in an emergency and includes a secure area for major financial firms which offers more specific advice and a communication method in the event of a major disaster. ■

Proposed dividends

The Accounting Standards Board (ASB) has issued FRS 21 *Events after the Balance Sheet Date*. The new standard will apply for years starting 1 January 2005 and will have the effect of implementing IAS 10 in the UK.

FRS 21 replaces SSAP 17 in 2005, with the main difference being that proposed dividends are not charged against profit and loss until they are paid, or approved by shareholders. Instead require disclosures in the notes to the financial statements will be required.

This accords with the generally-accepted view that dividends declared after the balance sheet date should not be reported as liabilities. This forms part of the phased convergence of UK accounting and international standards. ■

FSAP reveals its new plan of action

The EU's *Financial Services Action Plan* (FSAP) is an ambitious programme of 42 proposals to create a single market in financial services with the majority of the measures now either adopted or at the proposal stage.

Measures adopted as regulations automatically become law in Member States, but for the various directives the relevant legislation needs to be implemented at a national level.

The FSA, HM Treasury and the Bank of England have published a concise summary of progress so far and a draft timetable for the remaining stages, entitled *The EU Financial Services Action Plan: Delivering the FSAP in the UK*.

If references to Transparency Directive, Market Abuse Directive, etc, leave you confused, this briefing will bring you up to speed. Published at the same time is a second booklet, *After The EU Financial Services Action Plan: A New Strategic Approach,* which seeks views on the next steps to financial services integration.

Five priorities to guide further action are highlighted and cover the following:

- Better implementation and enforcement of EU measures affecting financial services;
- alternatives to EU regulation;
- better regulation;
- making the Lamfalussy arrangements work; and
- recognising the global nature of financial services.

Both documents are available on **www.fsa.gov.uk/pubs/other/fsap/**. ■

GE leads the way in bank billing project

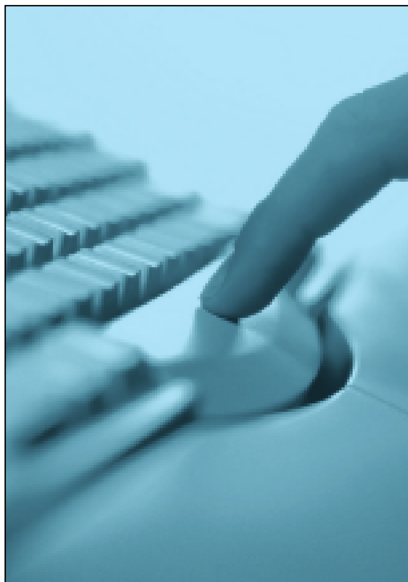
A new initiative aimed at helping treasurers understand what their companies are paying in bank charges, and ensuring that they receive this information globally in the same convenient and standardised electronic format, is being introduced across Europe.

Leveraging its success in North America, General Electric is leading an initiative which already includes 30 major multi-national corporations such as Honeywell International, Lucent Technologies, AT&T, Dell, Chevron Texaco, EDS, International Paper, PepsiCo, Pfizer, and UPS.

Electronic billing by banks is a common practice in the US and Canada. The International Bank Compensation (IBC) initiative is a concerted effort to spread the message for consistent electronic billing further.

At present, it is normal for international banks to directly debit a given company's bank account on a monthly basis for their fees, with minimal supporting detail. The IBC group is not looking to change international billing practices, but wants to ensure that its members receive an electronic billing statement which clarifies how compensation for bank services is derived. This should contain account-level, line-item descriptions of bank services, volumes, unit prices and total prices, in addition to account balance information and earnings credits (where relevant).

The electronic billing statement, which in the US uses standard charging codes promulgated by the treasury organisation – the AFP, allows a company to import the statements into excel or specialist account analysis software. By streamlining this process, GE has saved more than £3m in the two and a half years since its move to electronic billing in the US.



TWIST, the XML-based standards initiative, has become GE's European partner in this project.

If you are interested in finding more details about, or joining, this initiative please contact GE's Manager, Global Operations Services (Terence.Devine@GE.com) or TWIST (stephen.t.crompton@btinternet.com). ■

Overnight market set for change

New proposals by the Bank of England could radically alter the characteristics of the short-term sterling markets.

The Bank has been concerned over the volatility of interest rates in the sterling overnight market. Following initial consultation with market participants, including treasurers, it has produced proposals to alter some of its operational arrangements.

The objective is that the overnight rates stay more in line with the Monetary Policy Committee's (MPC) repo rate. This will lead to an essentially flat yield curve until the next MPC decision date and reduce potential risk. It will also reduce the rate benefits of spreading one's deposit business around and may even change the staffing needs in dealing rooms.

The Bank proposes giving banks more choice in their liquidity management by offering the possibility of holding interest-bearing balances at the Bank. These balances could then be used to finance wholesale payments made via the Bank's Real-Time Gross Settlement System as an alternative to the current process of borrowing from the Bank.

More banks would be given access to the Bank through holding reserves or by standing facilities.

The full report is available on: **www.bankofengland.co.uk/markets/money/smmreform040507.pdf**. ■

Guidance offered for employee benefit plans

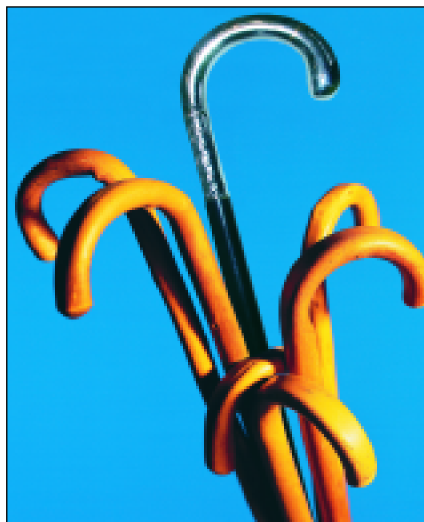
New guidance on defined benefit employee plans has been issued by the International Accounting Standards Board's International Financial Reporting Interpretations Committee (IFRIC).

The IFRIC's guidance D6 is targeted at organisations participating in defined benefit employee plans which involve more than one employer sharing actuarial risks, and will help them comply with IAS 19 *Employee Benefits*.

IAS 19 allows participants to use defined contribution accounting if the necessary information for defined benefit accounting is not available, or if there is no consistent and reliable basis for allocating the plan's assets and liabilities.

FRS 17 *Retirement Benefits* has a similar exemption from defined benefit accounting (and requirement for disclosures) where a participating employer is unable to identify its share of the underlying assets and liabilities in the scheme on a consistent and reasonable basis.

D6 requires participants to make every practicable effort to apply defined benefit accounting. This will be done by measuring the plan's assets and liabilities on the basis of assumptions appropriate for the plan as a whole. If possible, the plan is then allocated so that a participant recognises an asset or liability that reflects the extent to which the surplus or deficit in the plan will affect its future contributions.



The IFRIC's proposals are a response to concerns over IAS 19 being interpreted to allow participating entities in multi-employer plans an automatic exemption from defined benefit accounting. ■

Business combinations

The International Accounting Standards Board (IASB) has issued a new exposure draft entitled *Proposed Amendments to IFRS 3 Business Combinations: Combinations by Contract Alone or Involving Mutual Entities*.

IFRS 3, which was issued on 31 March 2004, excludes specific business combinations from its scope, notably:

(a) combinations involving two or more mutual entities; and
(b) combinations in which separate entities are brought together to form a reporting entity by contract alone without obtaining an ownership interest. This includes separate entities brought together by contract to form a dual-listed corporation.

The IASB is now proposing to amend the scope of IFRS 3 to include these combinations. In doing so, an acquirer must always be identified and should account for the combination using the purchase method.

However, the acquirer should measure the cost of the acquisition at the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. Goodwill only arises when consideration has been exchanged for control of the acquiree, amounting to the fair value of that consideration.

No change is proposed to the IFRS 3 scope exclusion for combinations involving entities under common control (for example, group reconstructions), which are not required to use the purchase method.

The proposals are intended to be applied to business combinations for agreement dates set from 31 March 2004 onwards. ■

ASB welcomes IAS 19 changes

The Accounting Standards Board (ASB) is seeking views on the International Accounting Standards Board's (IASB) exposure draft, *Proposed Amendments to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures*.

IAS 19 *Employee Benefits* permits actuarial gains and losses in a defined benefit employee pension plan not to be recognised in the period in which they occur, but spread over the service lives of the employees.

By contrast, FRS 17 *Retirement Benefits* requires actuarial gains and losses to be recognised immediately outside profit or loss in a statement of total recognised gains and losses. The IASB is therefore giving entities the choice of which treatment to adopt.

The IASB exposure draft is proposing changes to three aspects of IAS 19:

a) the introduction of an option for entities to recognise actuarial gains and losses in full as they arise, outside profit or loss, in a statement of recognised income and expense. This would allow entities to recognise such gains and losses in the same manner as is required by the UK's Financial Reporting Standard, FRS 17.
b) An extension of the application of multi-employer plan accounting to entities within a consolidated group that meet certain criteria.
c) The introduction of a number of additional disclosures. ■

OFR standards

In last month's issue we reported on the Department of Trade and Industry's (DTI) consultation on draft regulations for the Operating and Financial Review (OFR), published with a view to them coming into force on or after 1 January 2005.

The government intends to specify in legislation that the ASB will be the body that will make the more detailed standards for a mandatory OFR.

In May the ASB announced details of an advisory committee to assist the board in developing the first standards for an OFR. The ASB hopes to issue an exposure draft of the first OFR standard later on this year, to be finalised in 2005. ■

LMA loan terms brought up-to-date

A new edition of the loan documentation published by the Loan Market Association (LMA) was launched in May. Treasurers need to know how to respond when the arranger of a new syndicated facility says that the LMA documentation must be used. **ANDREW BALFOUR** and **JANE HANDS** of Slaughter and May explain.

The LMA was set up in 1996 by a group of banks, primarily to foster the development of the secondary loan market. One of the factors hampering the development of that market was – and still is – the range of differences in the terms of the underlying loan facilities. The LMA launched their project to publish a form of syndicated facility agreement – the LMA Agreement – with the twin aims of harmonising documentation and promoting efficiency in both the primary and secondary loan markets.

The LMA Agreement was settled by a working party including the British Bankers' Association (BBA) and the ACT and a number of law firms active in the loan market. It was first published in 1997 and has been revised since then, most recently in May.

ACT ROLE

At the launch of the LMA Agreement, the LMA, the BBA and the ACT put their names to a joint statement which sets out the shared aims of the three organisations in relation to the project.

Three essential points for treasurers are:

- use of the LMA Agreement is not mandatory;
- it is a starting point only; the parties are expected to negotiate changes to its provisions on individual transactions; and
- independent legal advice will always be necessary.

The ACT has been involved in the production of the LMA Agreement, which is designed for investment grade borrowers. It was not involved in all the documentation published such as the new leveraged loan facility, also referred to as the 'non-investment grade loan agreement.' As a result, the standing of that document has been questioned, particularly in the legal press.

WHAT IS THE LMA AGREEMENT?

The LMA Agreement is a 'plain vanilla' syndicated loan facility agreement designed with single A-rated investment grade UK corporates in mind. It contains certain concessions which, prior its publication, a well-advised borrower would usually have been able to obtain.

The LMA Agreement is not, however, a complete agreement. For example, it does not contain financial covenants or define material adverse effects – these are left to be tailor-made for the transaction in question. Other provisions specific to the borrower's business will usually also need to be settled.

There are six versions: single currency and multi-currency term and/or revolving facilities. Optional add-ons are dollar and euro swinglines, and a letter of credit facility.

THE ALTERNATIVES

Use of the LMA Agreement is not mandatory and so there are a number of alternatives:

- existing documentation;
- the LMA Agreement but with events of default etc lifted from existing documentation; and
- a form of agreement prepared by the law firm acting for the arrangers of the facility or, occasionally, the law firm acting for the borrower.

You should always be aware of a draft document described as 'LMA compliant'. What does that mean, exactly? In practice, it usually refers to something that is not an LMA Agreement, but which in certain respects (though not universally) reflects the approach of the LMA Agreement.

For new borrowers, use of the LMA Agreement is becoming widespread, but for longer established borrowers, re-use of existing documentation is still quite common.

ADVANTAGES AND DISADVANTAGES

Sub-investment grade and lower investment grade borrowers can usually obtain a more balanced starting point for negotiation using the LMA Agreement than they would otherwise. Notable borrower-friendly concessions include permitting rollover of revolving loans when a potential event of default is outstanding, materiality qualifications, and a qualified veto on loan transfers for the borrower.

There are, however, disadvantages. The main difficulty is often that, despite the repeated guidance from the LMA to the contrary, banks and their lawyers remain prone to argue that various provisions in the LMA Agreement are non-negotiable, as they represent 'market practice.' Countering this approach can require determination.

It should also be noted that an LMA Agreement may contain a number of features which some borrowers will find unacceptable. For example:

- lenders do not have to be banks;
- lender-friendly gross up provisions, tax and other indemnities are included;
- events of default catch the entire group;
- there are very restrictive negative pledge and covenants imposed in the event of disposals; and
- there are material adverse change event of default and representation clauses.

IF YOU USE THE LMA AGREEMENT

The LMA, BBA and ACT all recommend that you should obtain independent legal advice when using the LMA Agreement. You will need to adapt the overall terms of the LMA Agreement to meet its requirements even if you are a single A-rated borrower. For example, it is essential to negotiate suitable exceptions from provisions such as negative pledge and cross-default. Borrowers should not be deterred from negotiating in their own interests.

In order to see the changes made to the LMA Agreement in the first draft you receive, you should always obtain a mark-up from the drafting law firm; the LMA Users' Guide recommends this, but it rarely seems to happen. Seeing what changes the lenders have made to the base document at the start is an essential first stage in the loan negotiation process.

THE ACT GUIDE

The ACT, with assistance and sponsorship from Slaughter and May, has published the *ACT Guide to the LMA Agreement* which is freely available on the ACT website www.treasurers.org. This is a practical review of the LMA Agreement, designed for treasurers, and runs to about 70 pages. It provides an explanation of each clause, and points out the features that might be regarded as favourable to the lenders, and the alternatives that are more suited to the borrower.

KNOW YOUR CUSTOMER (KYC)

One of the main changes in the recently-revised

Extract from the ACT *Guide to the LMA Loan Agreement*

CLAUSE 8.2: CHANGE OF CONTROL

This Clause is contentious. It provides that a change of control of the Borrower can trigger the cancellation of Commitments and acceleration of outstanding Loans, and (optionally) release the Lenders on an individual basis from the obligation to fund Utilisations other than Rollover Loans. The Borrower will object to it on the grounds that:

- It cannot control the identity of its shareholders, and still less know who is acting in concert with them: it should not be penalised for matters beyond its control.
- The directors may not be able to satisfy themselves that it is in the best interests of the Borrower to agree to this provision.
- The Lenders do not need this protection: they have sufficient control over the Borrower, by means of the financial covenants, negative pledge, and restrictions on disposals and so on, for the identity of the controlling shareholder(s) not to matter.

The Lenders of course are likely to take a different view. They will explain that their assessment of the Borrower is based on the premise that its ownership will not change, and that any change in that situation would so markedly impact on their assessment of it that they would require at least the right to accelerate. The outcome of the discussion usually depends on the nature of the covenants, the strength of the Borrower and the effectiveness with which it puts its case.

Sometimes however this provision can assist the Borrower. If a takeover bid is an unwelcome possibility, the predator may be held up, or even put off, by the discovery that a change of control will or may terminate a loan facility or facilities, especially if other bank facilities contain cross-default provisions.

The new form of the Agreement published in May 2004 altered this Clause to provide two alternative versions: the parties are required to select which version is to be applicable, before signing. In the first version, on a change of control, the Majority Lenders can require the Agent to cancel the Facilities and declare the Loans due and payable to all the Lenders at the end of a notice period. In the second version, on a change of control, each Lender has the right, during a limited period, such as 10 days, to require the Agent to cancel its Commitment and declare the Loans due to it due and payable at the end of a notice period. The second version is clearly preferable from the Borrower's point of view, though the choice of the version which is to be applicable is liable to be an issue which the Arranger regards as chiefly a matter for the syndicate.

Whichever version is settled, the Borrower should negotiate a very long notice period, such as three months, to allow time for reorganisation. Borrowers are also sometimes able to alter the Clause so that the Lenders' right to cancellation and repayment is triggered only after the parties have negotiated the continuing provision of the facilities for a period such as 30 days.

The new form of Agreement published in May 2004 also introduced a new option in this Clause, under which a Lender will not be obliged to fund Utilisations other than Rollover Loans after a change of control.

The definitions of "control" and "acting in concert" need to be settled with care.

Market practice in relation to "control" is not particularly clear, with a number of definitions being used regularly. Borrowers often favour defining control by reference to the definition of a subsidiary in the Companies Act 1985 (majority voting rights, or membership with the right to appoint a majority of the board, or membership with contract-based sole control of majority votes). "Control" is also often expressed to have the meaning given in the Income and Corporation Taxes Act 1988, section 840, which generally means at least 50% of voting rights or control conferred by the Borrower's Articles. The Takeover Code definition requires only 30% of voting rights, and is therefore less attractive to the Borrower. The definition set out in section 416 of the Income and Corporation Taxes Act 1988 is insufficiently clear cut to be acceptable to many Borrowers.

The definition of 'acting in concert' is usually taken from the Takeover Code.

> 'The LMA, BBA and ACT all recommend that you should obtain independent legal advice when using the LMA Agreement. You will need to adapt the overall terms of the agreement to meet its requirements'

LMA Agreement is the introduction of a KYC provision. This stems from international concern to outlaw money-laundering. The legal and regulatory regime applicable to UK lenders requires them, essentially, to know the borrower before doing business.

However, guidance published by the Joint Money Laundering Steering Group indicates that identity checks are not required if the borrower is listed on a recognised stock exchange, or is a wholly-owned subsidiary of such a company. The regimes applicable to non-UK lenders are generally less stringent than those in the EU/UK.

The combined effect of the regulatory regime and LMA provisions is expected to be as follows:

- Listed borrowers should not be subject to KYC checks from UK-based lenders, unless there is a change in law after signing, or their status changes (eg a de-listing).
- Unlisted borrowers are likely to be subject to KYC checks from UK-based lenders before signing, though this arises by virtue of the banks' regulatory duties, rather than any contractual obligation. After signing, an unlisted borrower is required to provide KYC information to prospective UK-based lenders; it must also provide this information if there is a change in law or in the borrower's status. However, the new provisions stipulate that requests for information can be made only if they are reasonable, and are done solely for the lender or prospective lender to satisfy itself that it has fulfilled its legal obligations.

For suggestions as to how to restrict the impact of the LMA provision, please see the *ACT Guide to the LMA Agreement* (see extract above).

Andrew Balfour is a Partner at Slaughter and May.
andrew.balfour@slaughterandmay.com

Jane Hands is a Solicitor at Slaughter and May.
jane.hands@slaughterandmay.com

www.slaughterandmay.com