STANDARDS FOR TRUST DEEDS

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The company failures in the early 1960's and the investigation of these failures made investors more conscious of the contents of trust deeds under which debenture stock and unsecured notes are issued by corporate borrowers and in the intervening years considerable thought has been given as to how trust deeds can be tightened to give better security. The result of this has been a marked improvement in the standard of deeds as compared with ten years ago and the Life Offices Association of Australasia, in particular, is to be commended for taking a lead in this field.

However, in this process of tightening trust deeds there is a danger that emphasis is placed more on the tangible assets of the company as the security for the loan than on the company's earnings. The fixed interest investor's main requirements are the punctual payment of interest and the repayment of principal on the due date and these requirements can only be met if the company's earnings are sufficient to meet all its obligations under all circumstances. In previous issues of this journal there have been articles which discussed the sort of information that is required to enable an investor to make a judgement as to whether earnings will be sufficient. The object of this article is firstly to illustrate from recent company failures that reliance on asset coverage is not sufficient for the fixed interest investor and secondly to provoke further thought on three of the standards which are being proposed today for trust deeds to see whether, in all circumstances, they would permit a company to maximise its earnings.

Recent company failures have illustrated the two main reasons why the investor cannot rely on the assets charged as security. These reasons are well known:—

(i) **The book value of assets is not necessarily representative of the realisable value when a business fails.** There can be a substantial variation between the going concern value of an asset and the price it will realise in a forced sale. When the Chevron Hotel was sold in 1966 for $3.6 million the statement of profit and loss of Chevron Sydney Limited for the year ended 31st July, 1966, was adjusted to show a loss on realisation of assets sold of $6.5 million. Even the value of current assets can be overstated as the Receivers of Reid Murray Acceptance Limited found in 1963 when they estimated the realisable value of sundry debtors was $18.4 million as compared with a book value of $37.7 million.

(ii) **There are delays and other disadvantages incident to receivership.** In January, 1963, Receivers were appointed to Reid Murray Acceptance Limited. In April, 1964, an application had to be made to the Supreme Court of Victoria to clarify the situation regarding the security for a certain class of debenture holders. It was not until April, 1966, that the position was finally determined after a special Act was passed by the Victorian Parliament. This was a unique situation but the following table shows how long it can take for distribution to be made to debenture holders after receivership has commenced. The four examples were selected at random from recent failures.

Company	Date Receivership Commenced	Payments made to Debenture S'holders (per $100	Estimate of Total Payments to be made of stock)	Estimated Period of Payment
Chevron Sydney Ltd.	Dec. 1962	$31.5	$70	1966-74
Cox Bros. (Aust.) Ltd.	Aug. 1966	$30(a)	$40-50	1968-
Latec Investments Ltd.	Sept. 1962	$100+Int.	$100+Int.	1963-68
Reid Murray Acceptance Ltd.	Jan. 1963	$61(b)	$75(b)	1966
		$48(c)	$55(c)	1966-

(a) The Trustee estimated in November, 1967, that this payment would be made in March, 1968.
(b) Debenture Stock guaranteed by Reid Murray Holdings Ltd.
(c) Debenture Stock not guaranteed by Reid Murray Holdings Ltd.

In each case the fixed interest investor's requirements of punctual payment of interest and the repayment of capital on the due date have not been met and hence reliance on assets is not sufficient for the fixed interest investor.

Although it is generally recognised that the proposed standards that are currently being suggested are not to be regarded as inflexible it is important that the individual characteristics of each borrower should be considered when the trust deed is being drafted. In addition, it must be assumed that the deed will be in force for a number of years and the company must have sufficient flexibility to enable it to arrange its future borrowings on a satisfactory basis.

In the case of industrial companies it is usual, in Australia, for limitations on borrowings to be based on the total tangible assets of the company and its guaranteeing subsidiaries after certain adjustments have been made. It is becoming common for assets represented by shareholdings in and amounts owing by any non-guarantor related company to be excluded.

Two of the reasons for this are that it discourages on-lending and prevents the company from borrowing against shareholdings in a subsidiary which already may be a borrower in its own right.

There may be different reasons why a subsidiary cannot become a guarantor. It may be partly owned and the minority interest may object to giving the guarantee or it may, by virtue of the nature of its business, be detrimental to the subsidiary to give such a guarantee. If the non-guaranteeing subsidiary has a sound record of growth in earnings and is a substantial contributor to the group's profits, is it fair that the parent company gets no credit for this when determining the amount that it may borrow? This is an area in which great care must be exercised to obtain protection against the group becoming overborrowed, but is the present solution the most satisfactory or just the easiest to police?

Secondly it is proposed that assets represented by investments in any other non-guaranteeing company should be deducted (for the purpose of determining borrowing limitations) to the extent that they exceed 10% of total tangible assets. Let us examine two situations in which such an arrangement would not achieve the best results.

(i) Company A has a subsidiary whose profits are falling with no prospects of recovery. The company receives an offer to purchase this subsidiary from an extremely successful Company B, the consideration being shares in Company B. If the subsidiary had no borrowings in its balance sheet, Company A might be reluctant to accept the offer because it could reduce its borrowing margin, tangible assets being sold and replaced by shares in Company B. Yet by the sale of the subsidiary the security of lenders to Company A could be improved as assets which were not earning a satisfactory return on funds employed would be replaced by shares in Company B, which did meet the requirements as to earnings.

(ii) Company C is a profitable manufacturer which requires to ensure continuity of supply of raw materials at the right price, and distribution outlets for the finished product. An expert investigation shows that the most economical way of achieving these ends is to take up a minority interest in an already established supplier of the raw materials and also in a company which has the necessary distribution outlets. By so doing investments in Company C would exceed 10% of total tangible assets. If the company were to acquire the necessary assets to produce the raw material or to set up a chain of distribution outlets it would have tangible assets, perhaps of doubtful resale value, against which further borrowings could be made. It would be unsatisfactory if the company were to adopt the latter course but it might feel forced to, to maintain its borrowing powers.

In many debenture deeds the right to create prior ranking charges is only permitted over property acquired after the date of the trust deed for the purpose of financing such acquisition and for the renegotiation of prior ranking charges already extant. It is possible that such limitations could prevent a company from borrowing at a time when earnings are low or the company is making a loss and when it can produce detailed budgets to demonstrate that with the aid of such finance earnings could be re-established to a reasonable level within a period of one or two years. The lender* of such finance might require a security which ranked ahead of that of the debenture holders and it could be that the debenture holders' interests could be improved by such an arrangement. Under current practice such an arrangement would not be possible unless the approval of that percentage of debenture holders required to amend the Trust Deed was first obtained, and the company might be denied the opportunity of re-establishing its profitability. Receivership would follow with all the subsequent disadvantages to the debenture holders. It appears, therefore, that it may not be in the best interest of the debenture holders to insist on a permanent first charge position. Perhaps consideration could be given to permitting prior ranking charges to a certain limit to exist for a limited period of time.

It has been suggested a company should not be permitted to issue debentures if the annual interest commitments of the issuing company and the guarantors exceed one third of the aggregate of the average annual net profits, before interest and tax, for the three immediately preceding financial years. Overseas it is not unusual to see a clause of this type when the borrower is a holding company, and its subsidiaries are not guarantors, as it ensures that sufficient profits are remitted to the holding company to meet its fixed commitments. In Australia the intent of such a clause is to prevent a company becoming over-borrowed. However, disregarding the arbitrary nature of the clause, it does appear to deny that the fixed interest investor's security is future and not past earnings. There have been instances in recent years where such a clause would have prevented soundly based companies from raising fixed interest finance, perhaps for a number of years. It could cause a company which was not diversified, and whose product had been superseded by new technology, from embarking on a capital expenditure program which detailed research and analysis showed would be extremely profitable.

Any company which has tried to amend its Trust Deed, even to tighten it will give evidence as to the difficulty in getting amendments passed. If a provision is written into a deed which at a future date is too stringent and prevents a company's development, it may not be possible to have it amended.

All corporate borrowers accept that lenders will place certain limitations on their future borrowings but lenders have a responsibility to see that the proposed standards for Trust Deeds are continuously re-examined to ensure that companies have sufficient flexibility to maximise earnings.

*It is visualised in such a situation that a company would be limited as to whom it could approach for short-term finance, e.g., it could be its bankers who would have the necessary expertise to assess whether the provision of short-term funds would be to the long-term benefit of the company.