OPPORTUNITIES IN THE 1980'S A COMMENTARY ON SOME CURRENT LEGAL ISSUES FOR THE ACTIVE MONEY MARKET PARTICIPANT

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Introduction

I have been asked to give a practical legal overview on 5 or 6 selected areas of the money market. Of necessity, I am unable to deal in the allotted time with any one of these areas in much detail, which must be a great relief to you all, especially at this time of the day. You will find no footnotes in my paper and no references to any cases.

I propose to deal with some aspects of bills and notes, then touch on stamp duty and later look at some unusual securities and the concept of subordination. There is time for questions after my paper, and later, questions on the papers delivered on Tuesday and tonight can be put to the panel.

Before I deliver my paper, I have one note of caution. Most of the areas that I will be dealing with tonight do not have a developed body of Australian law governing their operation. Often concepts have been imported into Australia, and in some cases, existing Australian concepts have been borrowed for a different use. You cannot hope to have absolute certainty on these subjects. I suspect that the more certainty there is on a subject, the more inflexible that area becomes with the result that work becomes monotonous. Needless to say, I encourage you to take your problems to court so that we can have some Australian guidance – lawyers never lose in litigation.

1. Bills of Exchange

1.1 Introduction

Bills of Exchange used in the market place are inevitably unconditional orders in writing addressed by the drawer to the drawee, signed by the drawer, requiring the drawee to pay a fixed amount up to 180 days after the date of the bill to the order of the payee. Essentially, bills are negotiable instruments evidencing an assignable debt. Bills are stamped at a rate of up to 0.12% of their face value by affixing duty stamps to their face.

Bills are accepted by the drawee who specifies the place of payment of the bills. Bills are then endorsed in blank by the payee on their reverse side, which makes them bearer bills (Ss.13[3] and 39[1]). Thus they may be negotiated merely by delivery although market practice requires that on each negotiation of a bill the seller of the bill become an indorsee of the bill.

On due date, a bill that has been discounted or rediscounted in the market place will be presented for payment to the acceptor by the holder of the bill. Pursuant to the underlying agreement between the original parties to the bill, the "borrower" may have the right to roll-over the bill. In this case, the party being accommodated will be required to either furnish the acceptor with full cash cover to meet the maturing bill (viz. where the acceptor is the merchant bank), or, hand over a replacement bill and pay the merchant bank the amount of fees on the replacement bill. These fees could be grossed up by increasing the face value of the replacement bill.

A bill paid in due course by the acceptor is discharged. (S.64). Where the acceptor is the holder of a bill at its maturity, the bill is automatically discharged. (S.66).

In most cases there is an underlying agreement (whether it be a formal agreement or a letter of offer accepted by the client makes little difference), which contains the terms of the ongoing relationship between the merchant bank and its client. This will need to be one which includes an independent identity where the acceptor is the holder of a bill at its maturity. These facility agreements may be one page or 20 pages, depending on the transaction, and may be one or more of the following – acceptances, discounts, endorsements or loans with bill options. Many variations exist within these broad categories. These facility agreements resemble loan agreements, but, of course, although they contain many familiar loan provisions, you may not wish them to be loan agreements for many different reasons, not the least of which is stamp duty.

1.2 Lost Bills

What happens where a bill is lost? Suffice to say that because of the problems associated with a lost bill, you should be very security conscious about bills.

1.2.1 Immediately you become aware that bills have been lost or stolen, notice should be given to all parties liable on the bill and it would be prudent to put all regular users of the money market on notice by advising them of the loss or theft. Public advertisement of the loss should also be given in an attempt to put as many other people as possible on notice of the loss.

1.2.2 A person who finds a lost bill acquires no property in the bill himself and hence cannot sue the acceptor for payment of the bill.

If the acceptor pays such a person by mistake after receiving notice of the loss, he is still liable on the bill to the person who lost the bill upon that person presenting him with a copy of the bill, and an indemnity. (S.64).

If the acceptor does not have notice of the loss of the bill, he is discharged upon payment to the "finder" because he has paid to a holder of a bearer bill. (S.64).

1.2.3 The "finder", however, can discount a bill where only delivery is required and obtain value for it from the purchaser. If indorsement is necessary for transfer, the "finder" will be unable to negotiate the bill unless he forges the indorsement. Payment by an acceptor or other party to a forger will not exonerate the acceptor from his liability under the bill. (S.29).

Strictly, bills in the market place which have been indorsed in blank by the payee are bearer bills and may be transferred by mere delivery. (Ss.13[3] and 39[1]). However, market practice is for each party in the chain to indorse the bills. Accordingly, if the "finder" tried to transfer a lost bill in the market place without indorsement, the purchaser would be on notice that the transaction is unusual and it should enquire as to why the bill has not been indorsed by the person presenting the bill for payment, even if only to avoid the problem set out in 1.2.2 above.

If the "finder" went outside the market place, he could negotiate the bearer bill, and an honest but negligent purchaser of the bill with no notice of the loss of the bill is entitled both to retain the bill against the loser, and to compel payment from the parties liable on the bill. The acceptor who pays such a person, who in fact is a holder in due course, will be discharged from the bill. If the "borrower" has received value for the bill, the loser of the bill is the party that ultimately takes the loss on the bill. (Ss.43[2], 34 and 96).

1.2.4 A bill lodged with a lender as security for a deposit is always indorsed by the merchant bank borrower, and thus it will be difficult for a "finder" to benefit from the lost bill by using this possibility without forging an indorsement or indorsing the bill himself.

1.2.5 Where a bill is lost before it is overdue, the holder may call upon the drawer, and force the drawer if necessary, to draw a duplicate bill upon giving the drawer security to cover the drawer's potential double liability should the original bill be subsequently found and paid by the drawer upon presentment to another holder in due course. (S.74). The acceptor and indorsees cannot be compelled to sign the duplicate bill.

1.2.6 The party who lost a bill must demand that acceptor pay the bill when it is due, and give notice of dishonour, if necessary, otherwise his rights against the drawer and the indorsee will be lost. (S.50).

1.2.7 A party to a bill, such as the acceptor, cannot refuse to pay under a bill where that bill is lost, provided, it seems, that the party that pays against the bill is indemnified against all claims that may arise if the original bill is found and duly presented for payment by some other person.

1.2.8 What is the position where a lender who holds bills as security for his deposit loses those bills?

Generally these bills are given as security on the basis that they remain under the control of the lender. The merchant bank also retains the right to substitute new bills. Although possession is the cornerstone of the lender's security over these bills, loss of the bills does not automatically discharge the security.

One practical solution for the borrower is to sell the lost bill to the lender who lost the bill and let the lender look after the problems.

From a legal point of view, however, in that the lender will not have indorsed the bill and thus become liable on it as an indorsee, it is very much in the interest of the merchant bank to take the necessary precautions of giving the suggested notices described above. The merchant bank may have a claim against the lender for loss of the bill under the common law rules of negligence, depending, of course, on the circumstances surrounding the loss.

1.2.9 How long after the loss of a bill is a merchant bank at risk?

On due date, a holder must demand payment of the bill, and if paid, the bill is discharged and no further liability remains for any party on the bill. If the acceptor fails to pay, the drawer and indorsees are liable only if "the requisite proceedings on dishonour are duly taken". Accordingly, the drawer and indorsees can be reasonably safe wihin a few days after the due date if they have not received a notice of dishonour.

The acceptor, however, is only safe after he pays the bill because, unlike a cheque, a bill is not stale after 12 months. This situation is most unlikely to occur in practice as usually the person who loses the bill will obtain payment against an indemnity. The person who lost the bill then must carry the contigent liability under the indemnity he has given to the acceptor. A situation where a second payment of the bill by the acceptor, which in turn would result in a claim under the indemnity, could only possibly occur where the "finder" negotiated the bill to a holder in due course who promptly presented the bill for payment to the acceptor after the acceptor had already paid under the bill to the loser of the bill. (Of course, a person taking from the finder could only be a holder in due course if he took the bill before it was overdue in good faith [viz. done honestly, whether it is done negligently or not (S.96), for value and without notice of any defect in the title of the person who negotiated the bill (S.34).]

1.3 Forged Bills

The era of the basement forger with his hand printing press is nearly past. Technology has overtaken him. These days there are self correcting typewriters, self correcting pens and colour photostats via Rank Xerox. Maybe the time is rapidly approaching, if not already here, when signatures on bills must be verified by one means or another. I understand that some merchant banks do verify all signatures on bills they deal with, and if there is a sloppy signature on a bill due to a bad night out or a skiing accident, the signature is checked. If the person who supposedly signed the bill negligently acknowledges to an enquirer that the forged signature is his signature, he is precluded from later denying to that enquirer that the signature is a forgery.

1.3.1 A forged or unauthorised signature is wholly inoperative. As a general rule, there can be no holder of such a bill, even less a holder in due course. (S.29).

1.3.2 Once discovered, notice of the fact that a signature on a bill has been forged must be given to all parties to the bill, otherwise the discoverer will be unable to claim that the bill is forged should he be called upon to pay it.

1.3.3 If all market bills are bearer bills, the forgery rules are only of limited relevance in the market as the only forgeries that will affect the bill, will be those of the drawer and the indorsement by the payee.

Once the acceptor signs the bill, he is unable to challenge the genuineness of the drawer's signature as drawer. (S.59). He can challenge, however, the forged indorsement of the drawer where the bill is payable to the order of the drawer (viz. drawer and payee are the same person). He can also challenge the first indorsement of a third party payee. (S.51[b][ii] and [iii]). If these indorsements are forgeries, and the acceptor pays the forger or a subsequent indorsee, the bill will not be discharged and the real payee may claim payment of the bill.

1.3.4 In the case of bearer bills an indorsement is not necessary for negotiation. However, as I have mentioned earlier, it is market practice to indorse such bills. Notwithstanding this practice, a bill could be fraudulently indorsed and transferred by delivery to a third party who then becomes a holder in due course, and thus be able to enforce the bill against the acceptor. (S.34). The party whose signature was forged would bear the loss of the forgery because, presumably, the forger would have obtained the proceeds of the discounting transaction.

An unauthorised signature is treated in the same way as a forgery except that such a signature may be ratified.

Although not strictly relevant under this heading of forged bills, if a bill is materially altered without the content of all parties liable on the bill, the bill is avoided except as against the party who altered the bill, and subsequent indorsees. A holder in due course, however, can enforce the bill to the original amount of the bill (S.69) and if there have been indorsements between the time of the alteration and the time the holder in due course takes the bill, he can recover the additional amount against those subsequent indorsees.

1.4 Destroyed Bills

Intentional destruction or cancellation of a bill discharges the bill. (S.68).

Unintentional cancellation of a bill is inoperative, but the onus is on the party cancelling the bill to demonstrate that the cancellation was unintentional. A holder does not have the right to demand a duplicate of the bill which has been unintentionally cancelled or destroyed. However, upon proof of the destruction of a bill, legal action can be taken against parties on the bill, and secondary evidence of the contents of the bill will be admitted. It is unclear whether a plaintiff claiming on a unintentionally cancelled or destroyed bill need give the defendant an indemnity against claims by other people on the bill, something which he must do if the bill were lost. Logically it would seem that it is unnecessary, because in one case the bill is destroyed and thus out of circulation, and in the other, the cancelled bill would be produced to the court.

2. Promissory Notes

The legal advantage of money market promissory notes over bills of exchange is that they are one name paper viz. no party incurs a contingent liability on the note.

Money market notes differ from other notes because usually the borrower in the market place unconditionally promises to pay bearer the face value of the note on a fixed date at a fixed address. No interest rate is mentioned on the face of the note as it is invariably a discount note. In other circumstances, an interest rate is mentioned, and provided that the rate is certain, the note will be negotiable under the Bills of Exchange Act.

Notes only become complete when they are delivered to the bearer. Generally, the provisions of the Act relating to bills are applicable to notes, except that there is no acceptor. Notes can be indorsed, and if this is done, the maker of the bill (the borrower) is liable as if he were the acceptor, and the indorsee is liable as if he were the drawer (secondarily liable only).

Obviously, as notes are customarily drawn to bearer, great caution must be exercised when handling them. The principles relating to lost, forged and destroyed bills, outlined above, equally apply to notes.

3. Bills/Notes as Security for Deposits

3.1 Introduction

Bills and notes, amongst other instruments, are as a matter of course given to depositors as security for their deposits. These bills and notes are inevitably indorsed in blank by the merchant bank and are handed over on the basis that they may be recalled at any time provided satisfactory alternative security is given in their place.

Bills may either be bank/non-bank accepted and/or indorsed bills. Bank/non-bank accepted bills are more highly prized by borrowers than bank/non-bank indorsed bills. I understand that these sentiments are also reflected in the rate at which these bills are discounted in the market place. Sometimes, bank accepted bills have trustee status giving them wider market appeal. Where this is not the case and where a bill has been accepted by a bank, that bank is primarily liable to the holder on the bill. A bank endorsed bill, on the other hand, will only be enforceable against the bank where the acceptor has defaulted, and the holder has complied with the provisions of the Bills of Exchange Act on default by giving notice of dishonour forthwith to the other parties on the bill. If this notice is overlooked, both the drawer and the indorsees (including the bank indorsee) are released from their liability under the bill.

3.2 Present Situation

Lenders and their advisors in the market place have been troubled as to the effectiveness of the lodgement of money market instruments as security for cash deposits, when they have not been registered under S.100 of the Companies Act.

Most commentators have agreed that bearer bonds (the receipt of the Reserve Bank for the bonds and a direction to attorn are usually lodged as security), bills and notes (either endorsed in blank or to the lender, with a blank endorsement being preferable) may be the subject of a pledge and thus outside the ambit of S.100, with the result that a lender can be reasonably comfortable with these types of security. (The two notable features of a pledge are that the lender is placed in possession of the property given as security (viz the property must be transferable by delivery and not require a written transfer or assignment), and secondly, the understanding that the lender may sell the property in the event of default.)

There are more serious doubts with regard to the enforceability of securities consisting of semi-Government securities, certificates of deposit and company debentures. A lodgement of the above with a lender by way of security is probably considered an equitable mortgage, and if it comes within S.100, it should be registered.

3.3 Companies Bill, 1980

The draftsman of the Bill intended to clarify the position of all money market instruments by specifically exempting them from registration under the Companies Bill. Unfortunately he has not been wholly successful in clarifying the position in the current draft. Both the Australian Finance Conference, the Securities Institute and no doubt other industry groups have highlighted the deficiencies, and it is hoped that should the Bill be passed, amendments will be incorporated into the Bill to achieve the intent of the legislation.

4. Stamp Duty

State Governments view stamp duty as a method of raising revenue, whereas the money market looks upon it as an additional cost factor and sometimes an unnecessary complexity that distorts the market. The Government has recognised these complaints in part by administratively exempting some money market transactions from duty, and thereby foregoing substantial duty it might otherwise have received. On the other hand, it is unlikely that a market such as we have today would have developed in Sydney without such exemptions. Many of the people here might have been living in Melbourne, Brisbane or Canberra but for those exemptions.

Stamp duty considerations determine the term of bills, affect the form of bill facility that can be offered and are restricting the growth of a secondary mortgage market, to name but a few areas in which stamp duty has an everyday effect. Recently, Victoria increased the relevant interest rate from 14% to 15% for credit business transacted in the State. The N.S.W. Treasury has this matter under consideration.

A secured bill facility can attract substantial stamp duty. Duty at the rate of 1.5% of the amount of the facility can be payable on the facility agreement as a loan instrument, duty is payable on the bills themselves, and it could be payable on the subsequent discount of the bills at the rate of 1.5% of the amount of the accommodation. Duty is also payable on the security at the rate of 0.4% of the amount of the facility but there is a maximum of 1.5% loan instrument and loan security. In some situations, this maximum rate is a concession on the part of the Government. If the amount obtained under the facility is then on-lent to a joint venture company on similar terms, the exposure for duty is doubled. Luckily, this potential duty is never paid because of the legislative and administrative exemptions granted by the N.S.W. Government. If it had to be paid, there would be little finance business transacted in Sydney.

A loan with a bill option is treated differently for stamp duty purposes to a true bill acceptance/indorsement facility. Extra care must be exercised with a bill acceptance and discount facility. Problems may also arise where a lender provides funds against an acceptance and an in-house "discount".

Stamp duty is a subject that could be discussed for several hours. At every level of the market, and amongst lawyers themselves, there are differences of opinion. Industry groups have taken advice and, I am sure, each company represented in this room has done likewise. Five minutes of my thoughts on different aspects of duty and how it relates to the money market are apt to confuse.

Accordingly I will refrain from discussing the detail, but strongly suggest that stamp duty is a big potential cost factor in a borrowing if it is not adequately planned for, and may even require a well packaged commercial deal to be reviewed and subsequently changed. A transaction that is not "run of the mill" is a good illustration of when a lawyer should not be the last to be brought in, otherwise when he is brought in, the transaction could need wholesale restructuring just to overcome enormous potential duty.

5. Security

Security can take the form of a floating charge, a fixed charge over specific assets or a mortgage over land. All of these forms of security are well known in a general sense.

The money market has become more adventurous and securities, as that word is commonly used, now include security debenture stock, comfort letters and standby letters of credit.

As a preliminary comment before I discuss some of these securities, you must remember that securing a bill facility, as opposed to a loan, is securing a contingent liability.

Since 1976, language in the security covering only "moneys owing" may not be sufficient to secure the borrower contingent liability in a bill facility. The definition of "secured moneys" in a security must be widened to specifically include contingent liabilities usually found in a bill facility.

A second matter that must be watched with securities in the money market is the question of priorities. On one argument, new advances are made on each rollover of bills. If this argument is correct, a security holder must be careful that when he obtains notice of or gives consent to a second security over the same property, he needs to enter into a deed of priority regulating the priorities between himself and the second security holder. It is strongly arguable that if this is not done, the amount of the rollover negotiated after notice of the second security will rank in priority after the second security, so that the first lender will have a first security for the amount drawn at the time of the notice, but for the amount of new rollovers, he will only have a third security. Eventually, you will appreciate that after several rollovers, the first lender will only have a second security, and the second lender will have a first security and the reverse of what was intended will have occurred.

5.1 Security Debenture Stock

All modern debenture stock trust deeds provide for the issue of debenture stock as security for indebtedness or certain other liabilities in addition to the issue of ordinary subscription stock.

Care must be exercised that debenture stock can be issued to secure a bill facility. Some trust deeds do not permit the direct issue of debenture stock for anything other than for moneys owing, and accordingly such stock cannot directly secure a bill facility.

In many respects, security debenture stock is an unsatisfactory security. Firstly, it is often difficult for the lender to be assured that the stock has been validly issued. A lender must ensure that the provisions of the trust deed relating to the issue of stock are followed to the letter so as to obtain an enforceable security. Secondly, the lender must rely upon the trustee to administer and enforce the security. Thirdly, where a contingent liability is secured, often a lender can only prove for moneys actually owing at the time a Receiver is appointed to the borrower. Where bills are outstanding at this point of time and have not fallen due, this type of security could prove to be ineffective because until bills fall due, moneys are not owing. On the other hand, however, no other security is generally available where a borrower has entered into a debenture trust deed so that often it is a choice between security debenture stock or an unsecured bill facility.

5.2 Comfort Letters

Comfort letters are often just what they are called viz. not enforceable in law. As such, they will not represent a contingent liability on the balance sheet of the parent company giving the letter and must be of questionable legal value. If such letters are enforceable at law, there is every likelihood that at some stage in the development of accounting practices, they will be treated as a contingent liability on the balance sheet of the parent company. At one extreme, they are a letter from the parent company to the lender acknowledging the existence of its subsidiary and noting that it is aware of the proposed transaction. At the other extreme, they are a parent company guarantee that is best embodied in a formal guarantee agreement. You will find most comfort letters in the middle ground.

Please bear in mind that there is no such thing as a standard comfort letter, sometimes known as a letter of responsibility. For exchange control purposes, however, comfort letters are all treated as falling in the same category as a guarantee, and thus approval must be obtained before a foreign based parent gives its letter.

There are three discernable basic forms of parent company statements in comfort letters. The parent undertakes to the lender for life of the loan to the subsidiary:

1. to maintain its present participation in the subsidiary by not reducing its shareholding and its long term loan support to the subsidiary;
2. to exercise its influence on the subsidiary so that the subsidiary meets its financial obligations; and
3. to provide its subsidiary with the financial means to meet its obligations.

Variations on the above abound. One form that is popular is a statement by the parent confirming that it is the parent's present (and future) policy to provide its subsidiaries with the financial means sufficient to enable them to fulfil all their present and future obligations. Such a statement is comforting when given by a respected parent, but it may be nothing more than comforting if the crunch came, especially where the words "and future" were missing, because the parent could say that its business policy had changed since giving the letter. One commentator has suggested that a stronger expression, which is probably enforceable, is a statement that "it has always been the business policy of the parent company to provide its subsidiaries with sufficient means to fulfil their financial obligations, and it will act accordingly during the life of the loan".

Some letters talk about a maximum dividend payout, but care must be taken with these types of undertakings to ensure that this effect will not force the subsidiary into paying undistributed profits tax. A more colourful statement to the effect that "we will not financially exhaust (or drain) our subsidiary to the extent that it is no longer able to fulfil its financial obligations" is more vague. It probably prohibits the parent taking money out of its subsidiary by dividend or otherwise, but it imposes no obligation on the parent to inject money into its subsidiary and therefore is of limited value. Just imagine trying to prove this statement in a court of law, if an argument arose over an issue such as transfer pricing.

5.3 Standby Letters of Credit

Documentary letters of credit have been part of trade transactions for many years. Standby letters of credit, however, have been introduced into the market more recently. They have been used in USA as a legitimate method of avoiding the prohibition on American banks giving guarantees. Although sometimes loosely referred to as guarantees, they are not guarantees albeit serving the same purpose as a guarantee.

Standby credits are being used in the market on the account of the borrower to support its borrowings. Lenders are also using standby credits to participate the credit risk under facility agreements.

Typically, where a borrower arranges a standby credit, an agreement is entered into between the borrower and the bank providing the standby credit. The bank's contingent liability under a standby credit may be secured or protected by a charge, negative pledge or some such other arrangement. If the bank's liability is not secured at the time of issue of the credit, it will be secured upon the occurrence of an "internal" event of default, viz. a default under the agreement between the bank and the borrower, as this will often be the first sign that a drawdown under the standby credit is imminent. Anti-preference sections of the Companies Act may avoid the effectiveness of security taken at this time.

Upon default under the underlying facility agreement between the borrower and lender, drawdown cannot be achieved by the lender making merely a demand under the standby credit, as would be the case under a guarantee. The provisions of the credit must be followed strictly, which will always involve the lodgement of documents with the bank. Upon receipt of the documents, the amount of the standby credit must be paid by the bank regardless of the position of the underlying facility agreement, or the insolvency, or indeed the liquidation of the borrower. An essential feature of a standby credit is that at this stage it stands separate from both the agreement between the borrower and the bank, and the other agreement between borrower and its lender.

Under a guarantee, the paying bank would stand in the shoes of the lender pursuant to the doctrine of subrogation upon paying out the lender. However, the doctrine of subrogation probably does not apply to standby credits, so the bank must ensure that its account party, viz. the borrower, is liable in contract to it for the amount of the standby credit paid to the lender. Often a loan is deemed to have been made by the bank to the borrower at the time the paying bank pays the lender under the standby credit.

A lender can share the risk of a loan facility by use of a guarantee or standby credit. There may be income tax advantages in using a standby credit instead of a guarantee. Usually in these circumstances, the lender is reluctant to allow the issuer of the standby credit to have any direct relationship with the borrower. Accordingly the method of obtaining rights against the borrower in the event of default cannot be founded on contract between the issuing bank and the borrower – some other way must be found around this problem. Stamp duty can impact heavily on possible solutions to the problem. Also, often the lender will wish to have the sole right to pursue remedies against the defaulting borrower and thus act in a role similar to that of an agent/manager in a syndicated loan or bill facility.

So much for the types of agreements supporting the standby credit. What is this standby credit? It is usually an irrevocable, non-transferable and non-confirmed letter of credit made payable to the lender, or its bank, which may be drawn against within a specified time limit by the production of a sight draft drawn on the issuer together with, at a minimum, a certification by the lender that the amount due and payable to the lender has not been paid by the borrower. It is a credit governed by the Uniform Customs and Practice for Documentary Credits issued by the International Chamber of Commerce. The standby credit stands by itself independently of the underlying facility agreement between lender and borrower, and subject to fraud, it must be paid against presentation of the documents listed in the credit. These documents must strictly comply with the terms of the standby credit.

6. Subordination

Just as the general rules on the priorities of securities can be altered by a deed of priority or other agreement between the security holders, so can the general rule that all unsecured non-preferred creditors rank equally in a liquidation. The method through which this unequal ranking of unsecured creditors is achieved is called subordination.

The concept of subordination is widely used in USA. It was used sparingly in Australia until the last few years. Now even the major trustee companies have accepted the concept for borrowing ratio purposes and subordination provision has been incorporated into recently drafted trust deeds securing debenture stock and regulating unsecured notes. The state of the art, however, is relatively undeveloped if compared with the USA where subordinated notes of one kind or another are regularly on issue to the public. Subordination gives far more flexibility in the market place and, no doubt, when negative pledge borrowing becomes more widespread, subordination will be one of the few ways of achieving flexibility in the market place by providing for senior and junior unsecured debt.

There is no such thing as a standard subordination agreement. Each agreement must be looked at to assess its worth in a particular situation. A form used in USA will not necessarily be enforceable under Australian and English law which will not enforce a contract between two parties for the benefit of a third party. There is no Australian case law which deals in detail with subordination, yet in Australia, loans are being regularly subordinated.

Subordination agreements will most often be entered into between parent and subsidiary companies and a specific lender. The agreement may, for example, contain one or more of the following provisions:

1. the loan between the parent and subsidiary will not be reduced at all, or will only be reduced if the underlying loan is not in default. Alternatively, the agreement may provide that if as a result of repayment a specified ratio would be breached, the repayment will not be made;
2. any repayment of the loan made to the parent within 6 months of liquidation of the subsidiary will be paid by the parent to the lender in reduction of the subsidiaries' indebtedness to the lender, to the extent of any deficiency on liquidation of the subsidiary; and
3. upon liquidation of the subsidiary, the parent will hold all dividends recovered from the liquidator for the benefit of the lender until the lender has been paid in full;
4. the amount of the borrowing by the subsidiary will not be on-lent to the parent with or without security from the parent;
5. payment of the lender's advance to the subsidiary will be accelerated in the event of default by the parent or its subsidiary under the subordination agreement.

The liquidation provision is the most common feature of these agreements.

Subordination agreements can also be given for the benefit of not only a specific lender, but for all creditors. Such subordination agreements must be carefully drafted to avoid running foul of the principle of privity of contract. Usually a trust relationship is involved to get around this problem. Standard USA subordination documentation of this type, where privity is not a problem under the U.C.C., will almost certainly not be enforceable in Australia.

Conclusion

The money market has developed a lot over the last ten years – both in volume and sophistication. It will develop a lot more over the next ten years. You, the users of the market will play a large part in this process, but inventive commercial lawyers will also play a role.

The law in some areas of the Australian market is in its infancy. The law must grow but inevitably it will follow the market – the law itself is unlikely to be a market leader.

Stamp duty has been and may always be an inhibiting factor in the development of the market. Other countries have done away with stamp duty in relation to the market. It would be interesting to observe the changes in the market if the rates of stamp duty in N.S.W. and Victoria were to differ markedly. I suspect that the market would move to the more favourable centre, especially in this electronic age where such a change would not necessarily mean a wholesale move of personnel to the other centre.

To end on a happier note, there is an active money market functioning in Sydney and it has an optimistic future provided that it is prepared to change with the times. To date, it has demonstrated its willingness to change.

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