Industrial Company Debentures

BY J. H. D. MARKS, F.C.A.
Development Finance Corporation Limited

The first of the three parts of this paper appeared in the March issue of the Journal. It was primarily introductory and defined what was meant by "industrial company debentures". But we went on to discuss their advantages as a form of borrowing and their use as security for bank overdraft accommodation. This second part on important theoretical and practical problems is essentially a technical one, but necessary for an understanding of the degree of security provided for investors.

21. An industrial company that issues debentures may have one or more subsidiaries. These are themselves daily incorporated companies and each has a separate legal existence; whilst management personnel of a company group may tend to think of them as merely component parts of a larger organisation, they are in fact distinct entities and all the requirements of company law must be observed in respect of each one. However, there is usually a high degree of common control over the members of the group, and transactions between them are not at arm's length. In consequence there can arise opportunities for manipulation that may merely minimise the burden of taxation but which at worst could be to the deliberate disadvantage of creditors and others in their dealings with individual subsidiaries.

22. The proliferation of subsidiaries has created serious problems, and it is necessary to consider why they exist at all. In many cases there are good historical reasons such as past mergers and takeovers or even joint ventures formed with other interests to carry out specialised operations. An acquired subsidiary may have a valuable public image in its own right, and whilst of questionable social value it is also understandable for a subsidiary with accumulated tax losses to retain its identity until these have been absorbed by subsequent profits. In some cases geographical considerations make subsidiary operation more desirable than operation through the divisions of one company, and in others the existence of minority interests inhibits their winding up. However, many subsidiaries appear to have been formed or retained solely to minimize taxes and others to be retained solely because of costs associated with their elimination as separate entities.

23. Following changes in the companies legislation of the States and Territories, accounting and other costs of administering subsidiaries have increased. However, in view of abuses revealed by recent enquiries into failures of company groups, there seems to be no justification for their relative subsidisation by the community through the incidence of taxation. The tax advantage arising through the differential rate of company income tax applicable under Commonwealth law to taxable incomes of less than $10,000 (the abolition of which was recommended in the Report of the Commonwealth Committee on Taxation in 1961) provides an inducement in favour of operation through many subsidiaries, and the limit of exemption from payroll tax can have the same effect. In addition where subsidiaries are already in existence a barrier has been built by the States, through the incidence of stamp duties, against their elimination and even against the concentration of chargeable assets in the hands of a borrowing parent company; the unfairness of such duties has been recognised in the United Kingdom where stamp duties are not levied on bona fide transfers of property between associated companies. Certain features of Commonwealth and State tax laws have certainly been contributing factors in the undesirable proliferation of subsidiaries in Australia. It can only be reiterated that these features should receive the urgent attention of our taxing authorities.

24. Assuming that an industrial company proposing to issue debentures does have a number of subsidiaries, how may the interests of the potential debentureholders be safeguarded? It is usual to require each relevant subsidiary to join in the deed as a guaranteeing subsidiary in such a way that it gives a floating charge over its own assets and at the same time enters into a joint and several guarantee, with the other guaranteeing subsidiaries, of the whole of the principal, interest and costs related to the debentures or the exercise of remedies in the event of default; provision has also to be made for bringing in new subsidiaries as guaranteeing subsidiaries, and for releasing those which are sold or wound up in circumstances where their full value has been received by or retained within the company and/or remaining guaranteeing subsidiaries. This makes the debenture trust deed a long and complicated document, and involves additional costs in registration of the deed so that the charge is effective in relation to each party.

25. In practice cases arise where

This paper will be completed in Part III which will raise a number of practical aspects and inter alia discuss the standardisation of trust deeds and the statutory impediments to the development of an active market in Australian industrial company debentures.
it is not reasonable or it is not desirable to bring particular subsidiaries into a deed, e.g., some cases of subsidiaries with minority interests or overseas location. There must be good reason for any exclusion of a subsidiary, and provision should then be made for an adjustment to the permitted limit of borrowing and a limitation on amounts that may be invested in or otherwise advanced to any non-guaranteeing subsidiaries. The aim of a modern debenture trust deed is to achieve, in favour of the Trustee, an effective charge over all the assets of the whole group, and this is not completely effected insofar as any subsidiary is not a party to a deed; similar difficulties can arise with joint venture companies that are not technically subsidiaries, and in some cases this can be an area of considerable difficulty.

26. The whole approach must be practical as the company must be able to continue to carry on its business, but however highly the present management of a company may be regarded reasonable steps have to be taken to ensure that the interests of debentureholders are not likely to be adversely affected by future manipulation within a company group. There have been suggestions that companies legislation should be amended to make parents and subsidiaries responsible for each other's debts, but even if practicable in relation to unsecured liabilities it could be difficult to achieve in a fair way in regard to the secured debenture liabilities being discussed in this paper. There seems to be no alternative to a well-drawn trust deed which, as far as is practically and conveniently possible, brings in existing and future subsidiaries as both guarantors and providers of floating charges over their own assets.

27. It was assumed in the preceding section that debentures are issued by the parent company of a group. With the support of the guarantees and floating charges of the subsidiaries this is clearly the most desirable course. Should debentures be issued by a subsidiary the same degree of security can only be obtained by debentureholders if the issue is guaranteed and floating charges given by the parent company together with such of its subsidiaries as are not already parties to the trust deed as subsidiaries of the borrowing company. An appropriate case could arise where the borrowing company is carrying on a viable business in Australia, and wishes to obtain local funds, but its parent is located overseas. In practice the most that can usually be obtained is the unsecured guarantee of the overseas parent company without a floating charge and without bringing in any subsidiaries other than those of the Australian borrowing company. Where the overseas parent company is large and highly regarded, and subject to some restrictions upon the Australian borrowing company in relation to its transfer of assets outside Australia, this may be regarded as sufficient. Each case has to be considered on its merits, but at least in certain cases the Trustee may be satisfied to achieve an effective charge over all the Australian assets of the group supplemented by an unsecured guarantee of the overseas parent.

28. It is important that there be no misunderstanding about the nature of such a guarantee—if the parent company itself fails any liability under the guarantee would rank only as an unsecured debt. Furthermore there could be legal difficulties in enforcing the guarantee in another country, and the time taken could result in disadvantage to debentureholders. Nevertheless the guarantee has a considerable value as otherwise, if the Australian business failed, the parent could refuse to give its support. Indeed as each company is a separate legal entity it may as a duty to its own shareholders feel bound to refuse to give any such support—despite the fact that the borrowing by the Australian company may have been greatly facilitated by a world-wide group public image. The guarantee of the overseas parent could only reasonably be dispensed with in a limited number of cases, for example where the Australian borrowing company is very soundly established in its own right, holds assets that are particularly attractive as security, or has (or is in course of arranging) a substantial Australian equity content. Even in these justifiable circumstances it may be necessary to provide for the consent of the Trustee or impose some limitation upon payments to the parent, as otherwise if the Australian company experienced difficulties the overseas parent company may be in a position to obtain early repayment of an unsecured advance to the detriment of Australian secured debentureholders.

29. If the parent company is itself an Australian company there are very few circumstances in which potential holders of debentures to be issued by a subsidiary would be justified in not insisting upon both the guarantee and floating charge of the parent company. Recent spectacular business failures have underlined this need so very strongly that there is little more that can be said upon the subject. Indeed there is increasing support for the view that all borrowing should be effected directly by the parent Australian company, and that where necessary specific assets held by subsidiaries should be transferred to that parent. The stamp duty problems associated with this course has been mentioned in paragraph 23, and the untoward effect of this burden is again emphasized. In the meantime, and in the absence of insistence on a parent company guarantee and floating charge, there is a grave and continuing danger that the public will be misled into lending moneys to subsidiaries in the belief that their investment is secured by group assets or is sup-

The Australian Security Analysts' Journal June, 1966 13
ported by a moral guarantee that has no substance.

30. The only other point to be mentioned under the heading of Parent Companies is that even if debentures are issued in the most desirable form the group may be taken over by another company and so have a new parent superimposed upon its structure. This possible situation is normally dealt with by giving the Trustee power to enforce the security unless within a short period the new parent enters into a guarantee, gives such security for the guarantee as the Trustee may require, and enters into a covenant that has the effect of preserving the prior rights of the Trustee in relation to its charge over the assets of the borrowing company and its guaranteeing subsidiaries.

31. The long discussion about parent companies and subsidiaries has been necessary as, apart from a belief in the future profit-earning capacity of the borrowing company, the basis of the industrial company debenture is the security provided by the floating charge over a varying quantum of assets. It is of the utmost importance to know the extent of the assets charged, and to discount those held by a company group but which are not subject to the charge. In practice the quantum of assets is ascertained from time to time from the consolidated accounts of the company and guaranteeing subsidiaries, eliminating inter-company balances between them, deducting intangible assets, and usually making an adjustment in respect of investments in any non-guaranteeing subsidiaries or non-listed non-subsidiaries. The next step is to consider what limits should be placed on the amount of debentures that may be outstanding at any one time in relation to this quantum of relevant tangible assets to (i) ensure as far as possible the maintenance of a margin of security for debentureholders and (ii) warn the Trustee to take immediate action to acquire control over the assets should the limits be breached.

32. The total assets being used by a company group at any particular time derive from three sources—

(i) Shareholders' funds including revenue and capital reserves as well as paid-up capital.
(ii) Borrowings, whether secured or unsecured, and including loans on mortgage, bank overdraft, unsecured notes, etc., as well as the debentures, and
(iii) Creditors including such items as provisions made for income tax, payment of dividends, and long service and annual leave.

Because interest payable on borrowings is normally treated as an expense for income tax purposes, there is often a feeling on the part of company managements that it is preferable to borrow monies required to purchase additional assets rather than raise additional funds from existing or new shareholders.

33. On superficial analysis the use of borrowed funds may appear to involve less net cost; future rates of dividend declarations and future rates of company income tax payable cannot be foreseen, but on rational assumptions as to these rates it is often possible to show that gearing up of borrowed funds to meet the cost of an expansion in activities should result in a relatively higher rate of earnings on paid-up ordinary capital. However, this is not the whole story, as every extra dollar obtained by borrowing must increase the degree of risk being borne by the equity shareholder and increase the possibility that the company may become illiquid and unable to pay its debts.

34. A great deal of theoretical work has been carried out in recent years on this subject. There is certainly no unanimity of opinion, but it is widely accepted that a relatively small amount of borrowing could increase the return to equity shareholders without materially increasing their risk of loss of capital. With further increase in the use of borrowded funds, however, a point would eventually be reached after which the advantages of borrowing are outweighed by the increase in risk and associated decline in any rational market valuation of the company's shares. Purley from a financial point of view there may well be an "optimum" degree of borrowing which could vary from business to business and from time to time. Over-borrowing is of the most immediate concern to the equity shareholder but unsecured creditors and lenders, followed by secured lenders, are vitally interested in the continued healthy existence of the company, its continued ability to meet its debts, and the avoidance of need to realise its assets.

35. To protect the interests of the debentureholders the trust deed invariably provides, in one or more forms, limits of what a company may borrow; if these limits are sufficiently rigorous they incidentally serve to protect the interests of creditors, unsecured lenders and even the shareholders themselves. The mere imposition of these limits cannot guarantee the continued success of the company or even ensure the avoidance of loss by debentureholders, but they are necessary and do help. At the present time in Australia the normal standard required is that the total of secured liabilities (the debentures and any prior or pari-passu charges) may not exceed an amount equal to 40% of tangible assets and that the total of all liabilities and provisions (whether secured or unsecured) may not exceed an amount equal to 60% of tangible assets, the relevant terms being carefully defined in the trust deed. Appropriate limitations could alternatively be laid down by reference to shareholders' funds, but it is becoming usual to adopt tangible assets as the yardstick.

36. Reference is made to prior and pari passu charges in the next section, but the effect of the first of the two limitations is that so far as book values of assets are concerned the "cover" for debentureholders cannot without breach of the trust deed fall below $250 per $100 advanced. The financial situation of an industrial company can change very rapidly and in adverse circumstances the book value of assets may far overstate their then
realisable values, but this is generally accepted as a reasonable cover for industrial company debentures. The reason for the second of the two limitations is that even though the debentureholders are ostensibly secured, they could be adversely affected if overall liabilities of the company became too great; in adverse circumstances, pressing unsettled short-term liabilities may be paid off to keep the company alive before the Trustee has an opportunity, or even the legal right, to take action to safeguard the interests of debentureholders. The two limitations mentioned constitute the currently accepted standard; some old deeds include less rigorous limits and on this account debentures issued under them must be regarded as being relatively more risky, whilst there could be companies whose size or nature of business would warrant the laying down of lower limits.

37. It would be in the interests of debentureholders to provide that no prior or pari-passu charges could be created by the borrowing company. They would then, through the floating charge in favour of the Trustee, have in effect a clear first charge over the assets of the company. This course, however, is normally impracticable as not only may there be specific charges in existence at the time a trust deed is executed but the group must be given reasonable freedom to carry on its business and to expand its activities. It may through take-overs acquire companies with charges in relation to which there is no right of immediate repayment. The nature of its business may be such that the charging of a particular type of asset is a normal event, for example plant required to carry out specific construction projects. In particular, loans on mortgage are a normal incident in the financing of real property, and in view of the advantage of having a realty content in a company's assets it would be undesirable to inhibit the acquisition or improvement of real property. A Trustee could be empowered to consent to each proposed charge, but it is difficult to lay down criteria on which he could act and a borrowing company would certainly like to have some freedom of action.

38. A course frequently adopted in the past has been to specify existing charges in the trust deed, permit these to subsist and perhaps even allow them to be renewed or replaced, and allow future charges (to be advised to the Trustee but not requiring his prior consent) only on after-acquired real property (and perhaps in respect of later improvements to real property) up to 60% of the valuation of the real property concerned. So far as such future charges are concerned, the acquisition of additional real property would not be discouraged and normally there would remain a substantial interest in the real property as part of the security for debentureholders. If, however, the borrowing company is of such a nature that it holds a considerable amount of real property, the total of prior charges that could be so permitted could amount to a very substantial figure; furthermore it could be encouraged to dispose of encumbered existing property in order to replace it with property that could be mortgaged without the consent of the Trustee.

39. In recent deeds a more desirable form of limitation has been introduced, a simple limitation of the total of all prior and pari-passu charges that may exist at any time to an amount not exceeding 10% of tangible assets. There is then no occasion to specify existing charges in the deed itself, an artificial distinction between existing and after-acquired real property is avoided, permitted charges need not be limited to one particular class of asset, reasonable freedom is given to the company to carry on its business, and at the same time the interests of the debentureholders are reasonably preserved. Any prior or pari-passu charges are of course included with the debentures in the limit on the total of secured liabilities, and for example the obtaining of a loan on mortgage on real property will reduce the margin available for debenture borrowing. Nevertheless there must be a limit on the prior and pari-passu charges that may, without the special consent of the Trustee, be allowed to be created or be allowed to continue to subsist.

40. If too much freedom is given as to prior charges the debentureholders may, as stated in paragraph 8, end up as no more than second mortgagees; pari passu charges are in a rather different category, but if permitted at all their possible extent must be limited because they are outside the direct control or supervision of the Trustee for debentureholders. There is no particular magic in the figure of 10% but it would be undesirable to set a higher permanent limit in any circumstances and there may well be cases where the fixing of a lower limit would be justified. It may happen that at the time of execution of a trust deed the total of prior and pari-passu charges that must be allowed to continue to subsist (because of lack of right of repayment or reduction) may already exceed 10% of tangible assets. In such a case this limit should still be imposed, but one or two specific mortgages be allowed to subsist in addition—without right of renewal so that the limit of 10% became effective as soon as possible.

(To be continued)