What to keep in mind before entering into banking or finance transactions

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Banking, Cyprus

Introduction

The proper structuring of a finance transaction ensures the due performance of its terms – especially in situations of default and, more specifically, the borrower's insolvency. The lender should be able to enforce its claim if something goes wrong, such as when the borrower is unable to pay its debts or in winding-up or commencement of liquidation procedures. This update provides guidance to financial and banking institutions on what to consider when entering into such transactions, especially in relation to banking and finance transactions involving a Cyprus law element.

Proper security

As a first step, financial institutions should ensure that proper security is in place. What constitutes proper security will depend on the drafting of security documents as well as due registration.

Pursuant to Section 90 of the Companies Law (Cap 113), if a charge is registrable, it must be registered with the Registrar of Companies or it will be invalid. The obligations secured under a charge which has not been duly registered will not be recognised by the liquidator as secured obligations and the chargor will essentially be ranked at least *pari passu*, together with the other unsecured creditors. Obligations under an unperfected charge, therefore, will constitute unsecured obligations in the eyes of the liquidator and will rank together with the unsecured creditors. Assets which are subject to a registrable charge that has not been registered should be available to the general pool of creditors as if no such charge existed.

Similarly, other laws may be relevant in relation to the perfection of other types of security. For instance, pledges over shares in Cyprus companies should be perfected pursuant to the procedure prescribed by the Contracts Law or they will be invalid and unenforceable.

Solvency of borrower

Banks and lenders in general should ensure that the borrower is solvent at the time of entry into a transaction. Obtaining a legal opinion and receiving copies of up-to-date financial statements or management accounts may provide some level of comfort to the lender in relation to the likelihood of insolvency.

This is essential in the light of Section 301 of the Companies Law, which provides that in the event of a company's liquidation, any conveyance, charge, mortgage, delivery of goods, payment, execution or other act relating to property that took place within six months of the commencement of the company's winding up may be considered as a

fraudulent preference of its creditors and be set aside. A preference is considered to be fraudulent if it is intended to put a creditor in a better position in the event of the company's liquidation than the creditor would have been without such action. Any creditors that benefited from a fraudulent preference must repay the benefits obtained therefrom. Such benefits are considered to be sureties of the company for an amount equal to the value of such benefit.

Security created within six months will have to pass the test of whether it can be considered as constituting a fraudulent preference. In the normal course of events, this will not be a problem unless by creating the security an existing creditor is put in a better position than it would have been but for the granting of the security. In the absence of any intention to defraud the other creditors by favouring one creditor, security will be enforceable.

The Companies Law also provides that a floating charge created within 12 months from the commencement of the winding up is void unless it is proven that the company was solvent immediately after the creation of the charge.

Financial collateral arrangements

Financial institutions should also keep in mind that financial collateral arrangements provide additional comfort to lenders since, in a recent amendment to the Financial Collateral Arrangements Law 43(1)/2004, it was clarified that the power to reasonably execute or undertake any liquidation and valuation of financial collateral is not affected by the provisions of the Companies Law on examinership. It has been specified that the Financial Collateral Arrangements Law will be in effect irrespective of Part IV(A) of the Companies Law (which covers examinership). Further, Section 9 of the Financial Collateral Arrangements Law now provides that a close out netting provision takes effect in accordance with its terms irrespective of, among other things, the provisions of Part IV(A) of the Companies Law.

It has also been explicitly stated that irrespective of Part IV(A) of the Companies Law, the Financial Collateral Arrangements Law's provisions regarding the enforcement of financial collateral arrangements must be applied without prejudice to any requirements under the applicable law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commercially reasonable manner.

The examinership process (which came into force in mid-2015) aims to rescue a viable company with liquidity problems through reorganisation in an attempt to avert its liquidation. With the submission of an application for the appointment of an examiner, the company goes under court protection for four months from the date of the petition's filing, during which time enforcement cannot occur. Hence the importance of having a financial collateral arrangement in place becomes evident, since such arrangement would be enforceable in the event of examinership, while another type of security would not be (at least not without the consent of the examiner or the court).

In any case, the Financial Collateral Arrangements Law has the effect of disapplying certain insolvency provisions set out in the Companies Law by providing that a financial collateral arrangement and the provision of financial collateral under such an arrangement cannot be declared invalid, void or be reversed on the sole basis that:

- the financial collateral arrangement has come into existence; or
- the financial collateral has been provided on the day of the commencement of the winding-up proceedings or reorganisation measures, or within a prescribed period prior to such events.

Moreover, a financial collateral arrangement need not be registered with the registrar of companies in order to be valid against the company's liquidator. Where applicable, financial collateral arrangements can enhance the position of financial institutions in a corporate finance transaction.

Proper drafting

Proper drafting of transaction documents can protect financial institutions, especially in relation to their ability to enforce terms and conditions. It is important that an 'event of default' is properly defined to allow timely enforcement. For example, the commencement of an insolvency procedure should be included in an agreement as an event of default for the purposes of triggering the termination and enforcement procedures set out thereunder. The due drafting of provisions in relation to the enforcement of charges and pledges is also important, since in certain instances the possibility to enforce a pledge out of court will save the pledgee time and resources.

Comment

No banking and finance transaction is the same. However, as examined above, there are a number of considerations that financial institutions should keep in mind when negotiating the provision of loans and the entry into other financial arrangements. Securing proper legal advice would definitely enhance the position of such institutions in a wide range of transactions.

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