FAQS ON LOAN NOTES

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A note considering some common queries that arise when dealing with general purpose loan notes.

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SCOPE OF THIS NOTE

This note deals with queries relating to **loan notes** in the context of raising finance, that is, general purpose loan notes. This note does not relate to loan notes issued to a seller as deferred consideration in connection with an acquisition, or to **convertible** loan notes.

This note considers some common queries that arise when dealing with general purpose loan notes, for example, in relation to transferring and assigning loan notes, amending a loan note instrument, registering loan notes and cancelling loan notes. This note suggests answers to these queries, although the facts in any given situation will affect how a specific issue should be dealt with in practice.

For our precedent general purpose loan note instrument, see *Standard document, Loan note instrument*. The drafting notes contained in that document cover some of the issues raised here, but this guidance note is designed to provide easy to access and practical guidance on common queries.

USE OF LOAN NOTES

When would a loan note be used rather than a loan agreement?

A person borrowing money can evidence the contract for borrowing and repayment of that money by using a loan agreement or by issuing loan notes pursuant to a loan note instrument. The legal and commercial outcome is usually very similar.

A loan agreement in its simplest form is very easy to create, whereas loan notes in their common form are more complex to bring into being. Loan notes require a person to execute a deed constituting or creating the loan notes and then to issue loan notes to a subscriber or subscribers evidenced by a certificate with the conditions of the loan notes attached.

There are, however, a number of situations where a person is more likely to wish to issue loan notes rather than enter into a loan agreement and these include the following:

- **When the person is looking to raise money from the public.** This is because loan notes are securities that can be publicly listed whereas loan agreements cannot. Note, however, that private companies are prohibited from offering their securities to the public unless certain exemptions apply (*section 755(1), Companies Act 2006*).
- **Consideration loan notes (or vendor loan notes).** These are not general purpose loan notes, but are included here for ease of reference. Vendor loan notes are typically issued by the buyer of company shares to the seller (or sellers) of those shares as consideration for the share sale. The loan notes represent the element of the purchase price to be paid for the shares that the seller has agreed to defer.

  Sellers who receive consideration loan notes may avoid crystallising a taxable gain and "roll it over" into the loan notes. Whether such deferral is advantageous may depend on the vendors' entitlement to claim entrepreneurs' relief. For an example of a loan note instrument that can be used when loan notes are to be issued as an alternative to cash in a share purchase transaction, see *Standard document, Loan note instrument (share consideration)*. For further details on the tax consequences of receiving consideration loan notes, see *Practice note, Loan notes in share deals: tax FAQs.*
- **Investor loan notes (or equity investor loans).** These are not general purpose loan notes, but are included here for ease of reference. Investor loan notes are typically issued in a **private equity** transaction (for example, a buy-out) by a "newco" (a company set up to acquire the target business). In a buy-out scenario, newco will issue loan notes to the private equity investor(s) behind the transaction, who will usually provide the majority of their investment by subordinated debt funding such as loan notes (ranking behind the senior debt but before the equity capital) or quasi-debt funding (in the form of newco preference shares). Newco will use the monies raised from the issue of investor loan notes towards the acquisition of the target company. Investor loan notes may be secured on the assets of newco, the target company and each of the target's subsidiaries.

  Loan notes listed on a recognised stock exchange have the advantage of being exempt from withholding tax for investors if they fall within the quoted Eurobond exemption (*section 882, Income Tax Act 2007*)

Other features of a transaction that may suggest a loan note structure is more appropriate than a loan agreement structure include the following:

- Multiple lenders are to be involved, especially if not all lenders are identified when the loan notes are issued. This is probably the most common reason for issuing loan notes rather than using a loan agreement. Adding new lenders to a loan agreement is possible through accession deeds but is much more complicated

- The borrower does not need to raise an exact amount. Loan notes issues are better suited where the amount borrowed can increase as new lenders come on board. Loan agreements are more cumbersome where the total commitments under the loan are not fixed.
- If there are to be no obligations on the lender other than to advance the initial money. A loan noteholder does not need to sign anything. A loan note, therefore, has the advantage of simplicity especially if there are multiple noteholders. It will be difficult to document obligations to make further advances other than through a loan agreement.
- The loan terms are relatively straightforward loan terms that do not require lender consents or detailed information requirements for lenders. Simple arrangements like this can be under a loan agreement or loan notes but will often be drafted as loan notes especially where there are multiple lenders.
- The possibility that loan notes will be transferred during the life of the borrowing. Although interests under loan agreements can usually be easily assigned, it is harder to make partial assignments and bilateral loan agreements may get somewhat complicated if there are partial assignments. Loan notes are perfectly suited for partial or complete transfers – the borrower simply pays the registered holders from time to time as it would pay dividends to shareholders
- Non-bank lenders will be involved. Banks will prefer to lend on their standard terms or under market standard loan agreements.

However, none of these features conclusively point to a loan note structure.

There may also be specific tax planning reasons why loan notes are used in preference to loan agreements.

TRANSFERS AND ASSIGNMENTS

Is it possible to transfer loan notes?

Loan notes can be transferred if the terms and conditions of issue of those loan notes permit, but otherwise there is no entitlement for the loan noteholder to transfer. This is because the loan note terms will almost certainly include the issuance of a certificate to the loan noteholder and the terms will specify the rights of that holder.

It is usual to provide that loan notes may be transferred, although in private equity transactions where investors are likely to hold loan notes and shares, it will be usual to include similar restrictions on transferability of loan notes as apply to shares. There are also likely to be conditions prescribing minimum amounts of loan notes that can be transferred.

Can you assign some but not all rights under loan notes?

The loan note terms and conditions will be the starting point to determine the assignability of rights associated with the loan notes. It is likely that the issuer will only owe obligations to the loan noteholder or a transferee of loan notes in accordance with the terms and conditions of the loan notes. However, regardless of what the terms of the loan notes are, it should be possible for the loan noteholder to contract separately to transfer the benefit of some or all rights associated with the loan notes, but this will only create a personal right for the transferee to enforce against the loan noteholder and will not create a direct right against the issuer.

It would, however, be possible to draft terms and conditions of loan notes that allow for partial assignability of the notes, for example, by giving the loan noteholder the ability to assign the right to receive interest under the notes but not the right to receive the principal repayment. Care should be taken with this approach though as partial assignability would cause potential complexity in drafting the terms for, and administration of, the loan notes. It may also create difficulties in achieving a legal assignment under s.136 LPA 1925 as assignment of part of a debt does not fulfil the requirements of this section (*Standard document, Assignment of loan: Drafting note: Partial assignment*).

It is also worth noting that where loan noteholders are parties to an **intercreditor deed**, then it is likely that any assignee of the loan noteholder will be required to accede to the intercreditor deed as a condition of becoming a holder of the notes. The loan note terms will also usually be expressed to be subject to the terms of the intercreditor deed.

Is it possible for an issuer to novate its obligations under a loan note instrument to another company?

Most loan note instruments do not allow the issuer to **novation** its obligations to another company. This is because, understandably, loan noteholders will be wary of their right to receive payments from the issuer being transferred to another possibly less creditworthy obligor.

Occasionally, loan note instruments do contain clauses allowing substitution of the principal debtor, for example, on a reorganisation. This is only likely to be commercially acceptable where the issue is guaranteed by a more substantial company and the issuer is a **special purpose vehicle.**

If loan noteholders agree, then it will be possible to document the terms of a novation of the loan note instrument obligations by way of a novation agreement. However, because a novation is effected by extinguishing the existing contract and replacing it with a new one on the same terms, in most cases it is likely to be simpler to document the new arrangement by redemption of the existing notes and issuance of new notes by the new issuer.

Parties to any novation of loan notes should seek appropriate advice on the tax treatment of the disposal or acquisition of a loan note, including any related returns that have accrued but remain unpaid. For information on novation, see *Practice note, Contracts: novation.*

Are there any specific issues to consider when novating a loan note instrument?

Typically, loan notes are not negotiable instruments. That is, they are not designed to be transferred by the issuer. For this reason, they are unlikely to contain effective transfer provisions except in certain limited circumstances (see *Is it possible for an issuer to novate its obligations under a loan note instrument to another company?*).

Issues that should be considered if novating a loan note instrument include the following:

- Are the loan notes secured? If the loan notes being novated are secured, then novating the debt would need to be accompanied by a novation of the security. A novation of security is usually achieved in practice by releasing the existing security and granting new security (for information on novating a security interest, see *Practice note: overview, Transferring security interests: Novation*). If, however, the security is held by a common **security trustee** for the benefit of all noteholders from time to time, then the security will not need to be novated. For information on the use of security trusts, see *Practice note, Security trusts in finance transactions: overview.*
- What are the tax consequences of novating the loan note instrument? Loan notes may be issued as part of a complex commercial structure in which tax plays a significant role.
- Are the loan notes listed or unlisted securities? Private company-issued loan notes are unlikely to be listed except to gain an exemption from withholding tax (see *When would a loan note be used rather than a loan agreement?*). Listed loan notes may be subject to a myriad of statutory rules and regulations relating to the issuance of debt securities that will affect, for example, whether they should be issued or reissued to the public at large and whether a prospectus is required.

All of these issues should be borne in mind when examining the consequences of a novation of a loan note instrument, even where there may only be a single noteholder.

Often the economic effect of a novation of a loan note instrument may be better achieved by a redemption of the existing loan notes and issue of new loan notes by the new issuer. Depending on the circumstances of a particular transaction, this may be a more straightforward process.

How do you transfer loan notes and do transfers of loan notes need to be registered anywhere?

Transfers of loan notes are regulated by the terms of the loan notes themselves and there are no statutory requirements. For an example of loan note transfer provisions, see *Standard document, Loan note instrument: Paragraph 2, Schedule 3.*

Typically, where the issuer of loan notes is a company (as is usually the case though it need not necessarily be) loan note instruments and conditions attached to loan notes provide for a similar transfer procedure as for shares. Loan note transfers should be executed in the usual common form (for example, stock transfer forms) or another form approved by the directors. As for a share transfer, the loan note transfer form and certificate should then be delivered to the issuer so that the transfer can be registered in the issuer's company books and a new certificate issued in favour of the transferee.

A company is not required to maintain a register of "debentures" (a term that includes loan notes for these purposes (*section 738, Companies Act 2006 (CA 2006)*), but confusingly does not include the security document charging assets and undertaking of the company and commonly known as a debenture (see *Practice note, What is* *a debenture?*). So, in other words, a company is not required to maintain a register of loan notes showing transfers and current loan note holders, although the terms of loan note instruments will often require it to do so. However, a company is required to maintain a register of allotments of debentures (*section 741, CA 2006*). In practice, most companies also maintain a register of debentures in which they also record transfers and current holders, rather than only maintaining a register of allotments so as to comply with the CA 2006 requirements.

Loan note transfers do not need to be stamped (provided the loan is neither convertible into equity nor carries equity-like features (including certain profit-related returns)).

Provisions for transfer under a loan note instrument or conditions of issue of loan notes can be tailored to the borrower and the particular transaction (for example, the loan note certificates could be stated to be **bearer** certificates and so would be transferable by delivery of the certificate to a transferee), but this would be very unusual.

SECURITY

Can obligations under loan notes be secured?

Obligations under loan notes can be secured in the same way as a loan can be secured, and whether they are or not is a commercial decision negotiated by the issuer and the noteholders. How loan notes are secured will depend on the transaction they relate to so the nature of security taken to secure obligations under loan notes will vary from transaction to transaction. Security may be taken over all the assets of the issuer or only over certain key assets. For information on taking security, see *Quick guide, Taking security.*

If loan notes are secured then the loan note instrument will typically include a statement specifying that the obligations under the loan notes are secured by the relevant security document so that it is clear on the face of the instrument what security has been taken. In addition, usually loan notes are known by the interest rate applicable to them (their "coupon"), their redemption date as well as by whether or not they are secured, for example, the "10% secured loan notes 2025".

Where there are multiple loan noteholders and the loan notes are secured, it is usual to appoint one of the noteholders or a separate agent as a security trustee. The security is vested in the trustee who then has a duty to enforce that security in accordance with the instructions of the noteholders. The terms of the security trust will be set out in a security trust deed or in a schedule in the loan note instrument, or possibly the relevant security document. For information on security trusts, see *Practice note, Security trusts in finance transactions: overview,* and for information on security trust deeds, see *Practice note , Security trust deeds: overview.*

Priority intercreditor arrangements may be necessary where the issuer has granted other security over the same assets to other creditors. For information on intercreditor arrangements, see *Practice note, Perfection and priority of security: Subordination and intercreditor arrangements.*

Does a loan note instrument need to be accompanied by a separate debenture or is a loan note a form of debenture?

Terminology is confusing here. Loan notes are debentures within the meaning of *section 738* of the CA 2006 and restrictions on offering debentures to the public apply to loan notes. However, "debenture" is also used to describe a security document issued by a company that creates fixed and floating charges over all or substantially all of its assets. For more information on this distinction, see *Practice note, What is a debenture?.*

A loan note instrument will only need to be accompanied by a separate debenture (in the security document sense of the word) if the loan notes are secured. For information on secured loan notes, see *Can obligations under loan notes be secured?.*

Can obligations under loan notes be secured after the loan notes have been issued?

Obligations under loan notes can be secured after the loan notes have been issued. However, various issues will need to be considered.

The situation is analogous to security being granted for a loan after it has been advanced, so for more information on the issues to consider, see *Practice note, FAQs on security: Can security be granted after a loan agreement has been signed and a loan advanced?*. Note that, as is the case whenever security is being taken, if the issuer has any pre-existing debt or security arrangements, it may be restricted from granting security by a negative pledge. For information on what to do if the issuer is so restricted, see *Checklist, Can we create new security during term of existing loan?,* and for information on the consequences if security is created in breach of a negative pledge, see *Practice note, Negative pledges in loan transactions: What if security is created in breach of a negative pledge?.*

AMENDING A LOAN NOTE INSTRUMENT

Can a loan note instrument be amended to increase the amount of the notes?

It is possible to amend a loan note to increase the amount of the notes. Normally, amendments to a loan note instrument will require the consent of a specified majority of loan noteholders (usually three quarters). For an example of amendment provisions in a loan note instrument, see *Standard document, Loan note instrument: clause 14.*

However, if amendment of the existing loan note instrument is not practicable, possible or desirable, an issuer would typically be able to issue further loan notes on the same terms under a new loan note instrument without the consent of the existing loan noteholders. This is because usually a loan note instrument will not restrict further issues of debt and, unlike with share issues, existing loan noteholders will not usually have any **pre-emption rights** to subscribe for further notes. Note, however, that an issuer may be restricted from doing so under other documents of course (for example, under a senior debt agreement, or a shareholders' agreement), and a company's articles may contain restrictions on borrowings and exceptionally may contain restrictions on loan note issuance (for example, they may restrict the amount of loan notes that may be issued and who can hold them).

Where loan notes are secured, issuing new notes without the consent of the existing loan noteholders would be more problematic. This is because the terms of any security for the existing loan notes are likely to include a **negative pledge** that will restrict the issuer from creating further security. For information on negative pledges, including information on the consequences if security is created in breach of a negative pledge, see *Practice note, Negative pledges in loan transactions.*

A loan note instrument will typically be a deed poll (that is, a deed executed by the issuer alone that can be enforced by third parties in whose favour it is executed (the noteholders)). This means that any amendments to a loan note instrument executed as such will need to be made by way of deed. For information on deed polls, see *Practice note, Contracts: privity and third party rights and obligations: Deed poll,* and for information on amending deeds, see *Practice note, Execution of deeds and documents: Releases and variations.*

REGISTERING LOAN NOTES

Do loan notes need to be registered at Companies House?

Loan notes do not need to be registered at Companies House. However, if the issuer has created security to secure its obligations under the loan notes, if the issuer is a company incorporated in England and Wales then that security can be registered at Companies House in the normal way. For information on registering security at Companies House, see *Quick guide, Registering security at Companies House.*

Other than in the issuer's company registers, should I look to protect the existence of loan notes anywhere else?

As noted above (see *How do you transfer loan notes and do transfers of loan notes need to be registered anywhere?*), a company is not required by legislation to maintain a register of debentures (which term includes loan notes), but a company is obliged to maintain a register of allotment of debentures (which term includes loan notes), and that register is open to inspection at the company's registered office (or at a place specified in regulations under *section 1136* of the CA 2006). However, the terms of a loan note instrument will often require the issuer to maintain a register of loan notes showing current holders and transfers so, in practice, most companies will do so.

There is no obvious means of advertising to third parties the existence of an issuer's loan note obligations. A company is not obliged to register the existence of any loan notes it has issued with Companies House or any other person and while the loan note obligations will need to be recorded in the company's accounts, such obligations may not be visible if the company is not obliged to file full accounts.

However, one way in which third parties may become aware of the existence of loan notes is if the notes are secured and the relevant security is registered at Companies House. In this case, the existence of the relevant loan notes would be evident from that registration. Note, however, that registration of mortgages and charges under the current security registration regime is voluntary (although, in practice, most registrable mortgages and charges will be registered at Companies House because of the unwelcome consequences for the lender of not registering) so a search of a company's charge register at Companies House may not reveal the existence of its secured loan note obligations. For more information on the current security registration regime, see *Practice note: overview, Registration of charges created by companies and limited liability partnerships on or after 6 April 2013.*

CANCELLING LOAN NOTES

What is good practice in terms of documentation to cancel a loan note?

When a loan note is redeemed in accordance with its terms, then usually the holder will be required to return the loan note certificate to the issuer for cancellation. The issuer will usually destroy the certificate.

It is good practice for the company to record the redemption and return of the loan note certificate in its board minutes. In addition, if the company keeps a register of debentures, it should also record the cancellation of the relevant loan note in that register.

If a loan note is being cancelled by agreement between the issuer and the loan note holder, it is advisable to record the cancellation and any related terms in an agreement in writing between the issuer and the loan note holder.

TERMS OF A LOAN NOTE INSTRUMENT

Is it possible to issue half the loan notes under a loan note instrument in the future once the debt arises?

A loan note instrument can constitute "up to" a specified amount of loan notes. Unless specified in the loan note instrument, the issuer will not need to issue all the loan notes at the same time and will be able to issue them at separate times. So, it is possible to use a single loan note instrument to fund ongoing debt requirements by permitting issues of notes over a period. Loan notes will almost always bear interest from the date of actual issue rather than from the date of the loan note instrument.

It is also possible to defer payment of interest on loan notes and this may result in further loan notes being issued. Often an issuer (sometimes only with the consent of the noteholders) can elect to "roll up" the interest on the loan notes it issues so that it capitalises with the principal. Where this is the case, the loan note instrument will often require additional "PIK note" certificates to be issued in respect of the capitalised interest amounts (these may be referred to as "PIK certificates"). For more information on PIK debt, see *Practice note, Acquisition finance: debt for buyouts: PIK debt.*

Can the majority noteholders prevent an individual noteholder from enforcing repayment of the loan notes? Can the majority bind the minority into a decision to discharge the issuer's obligation to repay the loan notes?

This question is not straightforward. First, the language of the loan note instrument terms and conditions will need to be analysed. Do the terms suggest that each loan noteholder has an individual right to repayment of the principal and interest on it? Often loan notes will suggest that each individual noteholder does have such rights, for example, see *Standard document, Loan note instrument: clause 13.4.*

Note this right to payment, and to enforce payment, is separate from the event of default wording where usually a specified majority of noteholders can decide to accelerate payments of the notes if there is an event of default (for example, see *Standard document, Loan note instrument: clause 10*). Additionally, where loan notes are secured, a majority of the noteholders will usually be required to enforce, or direct the security trustee to enforce, any security securing the loan note obligations.

Occasionally, a loan note instrument may state that a noteholder's ability to enforce payment is subject to a requisite majority requirement. The precise terms of the drafting will be very important in a situation where an issuer requires a restructuring of loan notes and not all noteholders are fully supportive.

Where an individual noteholder either has a right to enforce payment of loan notes and the requisite majority do not want him to enforce that right, or, more radically, the requisite majority would like to discharge the company's obligation to repay the notes completely, then cases concerning oppression of the minority become relevant, for example, the following.

- *Greenhalgh v Arderne Cinemas Ltd [1951] Ch. 286* affirmed the principle that a special resolution might be impeached if its effect was to give the majority a benefit of which the minority were deprived.
- In *Redwood Master Funds Ltd v TD Bank Europe Ltd [2002] EWCH 2703 Ch*, Rimer J considered that this principle can also apply to creditors in a debt restructuring, although the discrimination against the minority will need to be manifest and to lead to the inference that the majority must have been motivated by dishonest considerations inconsistent with a proper exercise of power.

- The cases of *Assenagon Asset Management SA v Irish Bank Resolution Corp Ltd (formerly Anglo Irish Bank Corp Ltd) [2012] EWHC 2090 (Ch)* and *Azevedo v IMCOPA Importacao, Exportaacao e Industria de Oleos Ltda [2012] EWHC 1849 (Comm)* also suggest that oppression of the minority and threats of expropriation may be challenged in the courts even where a requisite majority appears to have the power to vote through amendments of the loan notes.

In addition to the terms of the loan note instrument, any noteholder seeking to enforce its debt or any related security should consider any restrictions that might prevent it from doing so under any related intercreditor document to which it is a party.

Is it possible to structure an issue of loan notes allowing for early repayments to be made to specific noteholders only, rather than to all noteholders?

Most loan note terms provide for pro rata early repayments, but it would certainly be possible to draft terms specifying that certain holders were repaid first, or that the issuer had a discretion whose notes to repay. In fact, noteholders may have different motivations with some holders preferring early repayment and others preferring to hold for longer, so express terms clarifying the destination of early repayments may be in all parties' interests.

Where an issuer is allowed to exercise its discretion then care may need to be taken to ensure that this discretion is exercised with a proper purpose and not, for example, applied to benefit loan noteholders with whom the issuer is connected or is otherwise motivated to favour or otherwise in an arbitrary or capricious manner. The court is likely to imply a term into the loan note instrument that the discretion may not be exercised in this manner.

Does a loan note instrument need to include an ascertainable redemption date for the loan notes?

It is almost universal for loan notes to have a specific redemption date, but freedom of contract would allow the parties not to include a specified redemption date if they so chose.

However, if a debt is never required to be repaid except on a default or at the option of the issuer, then it is possibly not characterised as debt at all but as a quasi-equity interest. This may have accounting and tax consequences, depending on the circumstances. If a loan note is issued by a company to its subsidiary in these circumstances (which would be unusual) then it may fall to be a distribution. For more information on distributions, see *Practice note, Distributions*, and for a detailed discussion on intra-group loans and whether these constitute distributions, see *Legal update, Distributions: CLLS and Law Society notes on intra-group guarantees and loans.*

What is the tax treatment of loan note interest? Should a loan note instrument contain a gross-up clause?

Tax treatment

UK law requires 20% income tax to be withheld on payments of interest unless an exemption applies or (broadly) the interest arises on loan notes that are due for repayment within the 365 days that follow their issue date. An issuer (other than a bank paying interest in the ordinary course of its business) is required to withhold tax at source on all payments of interest to all UK-resident individual noteholders. It must then account to HM Revenue & Customs (HMRC) for the interest withheld through quarterly accounting (Form CT61) and issue to each noteholder a certificate showing the tax deducted from each payment (for more information, see *Standard document, Loan note instrument: Drafting note: Tax treatment of loan notes*).

However, interest should be paid gross to all corporate noteholders who are beneficially entitled to that interest and either UK tax resident or, if tax resident overseas, have a UK permanent establishment through which they trade. For more on the tax treatment of UK resident companies and UK permanent establishments, see *Practice note, Companies: UK residence and permanent establishments.*

Interest may also be paid gross, or at a reduced rate, to noteholders who are resident in a country that has a suitable double tax treaty with the UK, and to facilitate payment gross it will be advisable for overseas corporate lenders resident in treaty jurisdictions to register with HMRC under the Double Taxation Treaty Passport Scheme. For more on double tax treaties generally, see *Practice note, Double tax treaties: an introduction.*

For a summary of the UK withholding tax rules on payments of interest and certain other payments, see *Practice note, Withholding tax.*

Grossing-up

As it is not uncommon for loan note holders to be subject to deduction of income tax at source, loan note terms sometimes provide that payments of interest are grossed up, although the more common position is that no gross-up is required for withholdings required by law.

It will be important for the parties to investigate the applicability of withholding tax at an early stage so that they have time to consider the practical consequences. Parties should also be alert to whether a gross-up clause is included as a standard "boilerplate" clause that may have important financial consequences for the parties.

For more information on withholding tax and other relevant tax topics, including transfer pricing and the UK tax treatment of corporate debt under the loan relationships regime, see *Practice notes, Tax for banking lawyers* and *Loan relationships*.