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Briefing note November 2012

Financial collateral remains a Gray area

Do you have sufficient "possession" or "control" for your security interest to qualify for protection under the Financial Collateral Arrangement (No.2) Regulations 2003 (the **Regulations**)? Since the decision in *Gray v G-T-P Group* two years ago, the meaning of those terms has been debated at length. Has a recent High Court decision in the Lehman insolvency settled the matter? Certainly more thinking has been provided on these and other questions, such as whether the Regulations have retro-active effect, and issues regarding general liens. One thing is clear – financial collateral is still a complex topic.

Background

Lehman Brothers International (Europe) Limited (**LBIE**) had, for some years, provided custody services to its Swiss affiliate, Lehman Brothers Finance SA (**LBF**). This relationship was documented in an English law governed master custody agreement entered into by the parties in 2003 (the **Custody Agreement**), which was a standard form of document normally used for LBIE's dealings with its clients.

In *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), the High Court had to consider a number of questions, including:

- Is LBIE's security interest under Clause 13 of the Custody Agreement properly characterised as a "general lien" (as it was described), or is it a charge or something else entirely? Clause 13 purported to create a "general lien" in favour of LBIE over the custody assets in respect of obligations owed by LBF to LBIE and also obligations owed by LBF to "any Lehman Brothers entity", coupled with a power of sale.
- Did LBIE have a security financial collateral arrangement under the Regulations (a **security FCA**)? Crucial to this analysis is whether LBIE had sufficient "possession" or "control" of the custody assets. Clause 9 of the Custody Agreement expressly permitted LBF to withdraw the custody assets save that LBIE had no obligation to deliver them where it believed that there might be insufficient assets to cover any exposure that LBIE had to LBF.

Lien, charge, other?

Counsel for both sides agreed that under English law a general lien could only apply to tangibles and certificated securities, not intangibles. Counsel had been invited to argue that the time might have come for English law to take a broader view, but chose not to, meaning that the court's decision was based on that starting premise. Consequently, Briggs J found it highly unlikely that the parties could have intended to create a general lien in the strict sense as it would have been incapable of applying to the overwhelming bulk of the property likely to be held as custodian by LBIE

Key issues

- To qualify as a security FCA, the collateral-taker needs to have possession or control.
- Intangibles? Possession is possible – but the collateral-taker holding the collateral will not, of itself, be sufficient.
- Showing "dispossession" of the collateral-provider will be key to establishing sufficient possession or control.
- A collateral-provider's rights to withdraw excess collateral or substitute equivalent value collateral may cause a charge to be floating, not fixed – but it could potentially still qualify as a security FCA.
- The Regulations do not have retro-active effect.
- A "general lien" over intangibles, with a right of sale, may in essence be a charge.

under the Custody Agreement. Instead, Briggs J analysed the security rights conferred (appropriation of property for the satisfaction of obligations, coupled with an express power of sale and rights as to application of proceeds) and concluded that, as between LBIE and LBF, they amounted to a charge.

The story does not end there, however. The charge covered obligations owed by LBF not just to LBIE but also to its affiliates, and without creating any agency or trust relationship between LBIE and those affiliates. Could it still be an effective charge? In Briggs J's view, yes.

"…*I can see no good reason why A should not confer a specifically enforceable right on B to have A's property appropriated towards the discharge of a debt which A (or someone else) owes C, without any requirement that B be C's trustee or fiduciary.*"

This may be considered a departure from previous thinking and could engender further debate.

Security FCA?

An arrangement which qualifies as a security FCA under the Regulations benefits from many protections, including rapid and non-formalistic enforcement, even in the insolvency of the collateral-provider, and the disapplication of certain formalities, such as the requirement to register charges, and certain insolvency law provisions. But there is no such thing as a free lunch – a number of tests must be satisfied to qualify for these protections. One such test, the requirement that the collateral be delivered, transferred, held or otherwise designated so as to be "in the possession or under the control" of the collateral-taker or a person acting on the collateral-taker's behalf, has been the subject of much legal debate in the past few years.

Possession or control

The first opportunity for the English courts to decide the meaning of the "possession" or "control" requirement came in May 2010, in *Gray v G-T-P Group Ltd (Re F2G Realisations Ltd)* [2010] EWHC 1772 (Ch). Vos J's decision caused much consternation among commentators, as it largely ruled out possession in the context of intangible property and, in relation to control, equated the test under the Regulations with that required to obtain a fixed charge.

Responding to concerns raised by the industry, when the Treasury amended the Regulations in April 2011 to bring them in line with recent changes to EU Directive 2002/47/EC (the **Directive**) they also introduced a new inclusive definition of "possession" (though no clarity was provided on the meaning of control).

So, did LBIE have the necessary possession or control of the custody assets? The short answer is that, yes, it would have satisfied the requirements - *if* the charge had not been extended to cover obligations owed to LBIE's affiliates as well as to LBIE itself (when LBIE's rights of retainer applied only to LBIE's exposures). But the long answer is well worth a read as it sheds light on what is expected from collateral-takers if they are to demonstrate sufficient possession or control under the Regulations.

The court reached the following conclusions:

- **Interpretation:** As the UK implementation of an EU directive, the Regulations are to be interpreted, so far as possible, consistently with the meaning and purpose of the Directive.
- **Possession of intangibles:** It would be wrong to limit "possession" in such a way as to exclude application to intangibles, which are "*the very stuff of modern financial collateral*".
- **"Dispossession" key to possession and control:** The simple fact of the collateral-taker actually holding the collateral is not, of itself, enough: "…*both "possession" and "control" mean something more than mere custody of financial collateral by the collateral taker under an agreement giving the custodian no more dominion over it than that of a pure nominee*".

  Rather, the terms upon which the collateral is provided, or delivered, transferred, held, registered or otherwise designated, must be such that there is shown to be sufficient possession or control in the hands of the collateral-taker for it to be proper to describe the collateral-provider as having been "dispossessed".
- **Control:** Is it always necessary to show control?
  - Possibly not. There may be cases (though Briggs J gives no examples) where the collateral is "sufficiently clearly" in the possession of the collateral-taker that no further investigation of its rights of control is necessary.
  - However, in other cases, as in *Gray*, it will be necessary to analyse the degree of control conferred on the collateral-taker.
  - There may be some cases, in particular where there is

no delivery, transfer or holding to or by the collateral-taker, but merely some form of designation, where the collateral remains wholly in the possession of the collateral-provider, but on terms which give a legal right to the taker to ensure that it is dealt with in accordance with its directions.

Vos J was correct to conclude, on the facts before him, that the possession or control test was not satisfied in the *Gray* case (see our July 2010 briefing Financial Collateral: Float Controls for a discussion of the *Gray* decision).

- **Floating charges, substitutions and withdrawals of excess:** Some floating charges may be capable of qualifying as security FCAs: "*as LBIE concedes, the mere existence of a right of substitution is a badge of a floating charge, but such a right does not prevent an otherwise compliant floating charge from qualifying as a security financial collateral arrangement*".

  In the *Lehman* case, the charge, which the parties had agreed was floating, might actually have qualified as a security FCA if it had been granted in respect of obligations owed to LBIE alone and not extended to obligations owed to any Lehman Brothers entity - subject to the question of conduct (more on this below).

  (Briggs J refused to analyse the Custody Agreement as creating separate security interests for those separate classes of LBF's obligations, one compliant with the Regulations and the other not – this may raise further question marks over "mixed security" arrangements (which are anyway the subject of debate).)

  However, because the charge was granted in respect of obligations owed not just to LBIE but also to LBIE's affiliates, whereas LBIE's right of retainer applied only to LBIE's exposures, Briggs J concluded that LBF's rights went beyond rights of substitution or withdrawal of excess collateral (treating "excess" as referable to the whole of the secured obligations) and therefore the possession or control requirement of the Regulations was not satisfied.

Form over substance?

If the court had decided that the charge would have qualified as a security FCA on the face of the documentation, could the conduct of the parties have altered this conclusion? Interestingly, Briggs J thought not (that is, in the absence of the arrangements being a sham – and this had not been suggested). Why? The Custody Agreement expressly entitled LBIE to refuse to deliver property in certain circumstances. This is to be contrasted with the facts in *Spectrum Plus* [2005] 2 AC 680 and *Agnew's case* [2001] 2 AC 710, where the relevant agreements were silent as to the way in which the account into which the charged cash was to be used. Briggs J considered that, in the present case, the mere non-use of LBIE's right of retainer would have been insufficient to swing the balance against a conclusion that the qualifying conditions of the Regulations had been satisfied.

Arrangement need not be bilateral

One of the arguments deployed by counsel for LBF was that the charge could not be a qualifying security FCA, because of the multilateral, rather than bilateral, nature of the arrangement (in the sense that the charge covered obligations owed by LBF to LBIE's affiliates as well as to LBIE itself). Briggs J was not persuaded by this and concluded, after reviewing a variety of background information, that the Directive was not intended to apply only to security arrangements between two parties.

Purpose

Another argument raised by counsel for LBF (which again gained little traction with Briggs J) was that the charge did not satisfy the statement in the Regulations (which, notably, does not feature in the Directive) that a security financial collateral arrangement has the purpose of securing "financial obligations owed to the collateral-taker". Briggs J rejected this argument and found that a security arrangement can include a security interest granted to secure financial obligations owed to third parties and still be a qualifying security FCA.

Retroactivity?

Did the Regulations come into force too late to be capable of applying to the Custody Agreement in any event?

As the court had already found that the charge was not a qualifying security FCA, it was not strictly necessarily for it to answer this question. However, Briggs J briefly addressed the issue and concluded that the Regulations do not have retro-active effect.

Further, Briggs J considered that the relevant date is that of the entry into the transaction which sets up the arrangement rather than the provision of security under it – consequently, the fact that much of the charged property was posted after the Regulations came into force was not

relevant to the determination of the applicability of the Regulations.

Other issues

British Eagle

Briggs J expressed "grave doubt" as to whether the principle that no property should be distributed, in an entity's insolvency, save in line with the UK insolvency code - the *British Eagle* principle - applies automatically to all contracts governed by English law regardless of whether the assets or the parties are likely to be subject to an English insolvency scheme of distribution. (Contrast this with obiter dicta in the first instance decision in the *Belmont* case [2009] EWCH 1912 (Ch).) As Briggs J had concluded that a charge, rather than some other sort of contractual provision or flawed asset, had been created, no decision needed to be reached on this point.

Client money

The *Lehman* case confirms that there is, in principle, no objection to an entity which holds client money for a client being granted a security interest over that client's beneficial interest under the client money trust.

Affiliates

As discussed above, the extension of the secured obligations to debts owed to LBIE's affiliates did not prevent there being an effective charge (though, together with the drafting of the retention of rights provision, it did prevent that charge from qualifying as a security FCA). But what of LBIE's affiliates? Briggs J held that the charging clause was not sufficient (without further drafting) to create rights for LBIE's affiliates under the Contracts (Rights of Third Parties) Act 1999 to enforce the charge, or constitute LBIE a trustee of rights under the charge for its affiliates.

Conclusions

It is to be welcomed that the first case in the English courts since *Gray* to consider the meaning of "possession" and "control" under the Regulations has a fully reasoned judgment. The case nevertheless gives rise to many practical questions as to how a security FCA can be put together safely. The application of the Regulations in the context of security based collateral arrangements remains difficult terrain – and the consequences of getting it wrong are potentially severe.

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