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Briefing note — November 2016

European Court of Justice provides its first ever ruling on "possession or control" under the Financial Collateral Directive

Four years after Briggs J's judgment in the case of *Re Lehman Brothers International (Europe) (in administration) [2012] EWHC 2997 (Ch)* (Re LBIE), the Court of Justice of the European Union (CJEU) has given its first ever ruling on the question of what constitutes "possession or control" of financial collateral under the Financial Collateral Directive (FCD) following a referral on questions of EU law by the Supreme Court of Latvia. The CJEU's judgment does not materially advance the current English law position on this vexed question. However, the CJEU's responses to the Latvian court leave open a number of important issues that will do little to allay concerns of market participants and practitioners about the extent of legal uncertainty in this area.

The Facts

On 14 April 2007 the predecessor entity of Private Equity Insurance Group SIA, a Latvian limited liability company (the **Depositor**) opened a current account with Swedbank AS, a Latvian bank (the **Bank**). The account terms (which we understand were governed by Latvian law) contained the following clause:

'The Customer's monies in the Account, present and future, shall be pledged to the Bank as financial collateral and shall cover all debts owed by the Customer to the Bank. In the event that the Customer fails to provide the monies necessary to make the payments in the current account, or in any other situation in which, pursuant to the present contract or any other contracts entered into with the Bank, or on any other legal basis, a debt owed by the Customer to the Bank arises, the Bank shall be entitled to settle that debt by enforcing the financial collateral arrangement, that is to say, the Bank shall be entitled, without giving prior notice to the Customer, to debit (transfer) from the Account the amount owed. …'[1]

On 25 October 2010 the Depositor entered insolvency. The Depositor's insolvency administrator opened a new account with the Bank on the same terms. On 8 June 2011 the Bank debited 192.30 Latvian lats (approximately EUR 274) from the Depositor's account for account fees that were incurred by the Depositor prior to the insolvency.

[1] The language of the national dispute was Latvian and we assume that the contract in question was written in Latvian.

Questions asked by the national court

Question 1

The Latvian court expressed doubt as to whether the FCD was intended to apply to ordinary bank accounts. In view of references to the Settlement Finality Directive (**SFD**) in the recitals to the FCD, the Latvian court asked the CJEU to confirm whether, insofar

as it applies to cash, the FCD is restricted to cash credited to bank accounts used for securities settlement or whether it also extends to ordinary bank accounts.

Question 2

The Latvian court expressed doubt as to whether the priority given to holders of financial collateral would be compatible with the general principles of *pari passu* treatment of creditors in insolvency. The Latvian court therefore asked the CJEU to confirm whether the purpose of the FCD was to ensure that banks had priority over other creditors (e.g. employees, national tax authorities and secured creditors with non-financial collateral security) in the insolvency of a bank's customer.

Questions 3 and 4

Latvia's implementation of the FCD extends the scope of eligible parties to natural persons. In the FCD, natural persons are not among the categories of person permitted to be within the scope of the regime. The Latvian court asked whether the FCD was a minimum or a maximum harmonisation Directive and whether it was open to Member States to extend the regime to categories of person ostensibly excluded from the FCD. The Latvian court also asked whether Article 1(2)(e) of the FCD is a directly applicable provision. That Article brings non-natural persons, including unincorporated firms and partnerships within the scope of the FCD provided that their counterparty is either a public authority, central bank, a financial institution subject to prudential supervision or a central counterparty, settlement agent or clearing house (each as defined in the SFD).

Question 5

Finally, the Latvian court asked whether, in the event that the scope and purpose of the FCD proves to be narrower than the scope and purpose of the Latvian implementing legislation, this could have the effect of invalidating a Latvian law governed clause on financial collateral such as the clause at issue in the main proceedings.

Answers given by the CJEU and observations on the judgment[2]

Question 1

The CJEU confirmed that monies credited to an ordinary bank account are capable of being within the scope of the FCD regime, regardless as to whether or not the account is used for securities settlement. The CJEU observed that despite references to the SFD in the recitals to the FCD, other clear statements in the latter revealed that the intention of the FCD was to provide an effective regime for financial collateral and it therefore went beyond the SFD and other legislation predating the FCD such the Winding Up Directives for Banks and Insurers and the EU Insolvency Regulation.

The CJEU also held that the FCD was intended to cover collateral for "*ordinary pecuniary obligations*" in general terms. From this it is clear that an "all monies" charge should not be incapable of constituting a security financial collateral arrangement simply because of the breadth of obligations covered by the security interest. These aspects of the judgment are uncontroversial and provide helpful confirmation of the intended purpose and effect of the FCD.

However, other aspects of the judgment are potentially less helpful and present some important unanswered questions. First, the CJEU held that money credited to a bank account can only constitute financial collateral where the account credit happens prior to the onset of insolvency (or on the day of the commencement of insolvency proceedings in cases where the collateral taker proves that it was not aware nor should have been aware of the commencement of proceedings at the time of the credit). Secondly, the CJEU held that money credited to a bank account can only constitute financial collateral if the depositor was "*prevented from disposing*" of the money after its deposit.

The first point is particularly important to the corresponding Latvian litigation in which it appears that the money in question may have been credited to the account after the commencement of insolvency. The CJEU's decision on the timing of credits clearly accords with the express wording of Article 8 of the FCD. However, the CJEU's ruling suggests that if a security interest includes within its scope any "after-acquired" property (i.e. property coming within the scope of the security interest after the onset of insolvency) then the benefits of the FCD regime (such as the ability to ignore insolvency moratoria) are unavailable to the collateral taker in respect of that after-acquired property.

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[2] Judgement of the European Court of Justice dated 10 November 2016 in Case C 156/15 - Request for a preliminary ruling under Article 267 TFEU from the Augstākā tiesas Civillietu departaments (Supreme Court, Civil Division, Latvia), made by decision of 11 March 2015, received at the Court on 1 April 2015, in the proceedings Private Equity Insurance Group SIA v. Swedbank AS.

As for property already subject to an FCD compliant security interest *prior* to the insolvency, the CJEU's verdict may raise questions as to availability of FCD protections in respect of that collateral because of possible "tainting" issues connected with the commingling of financial collateral and non financial collateral in the same account. The CJEU itself said nothing about this specific question but the decision in Re LBIE has already raised fears in certain quarters on broader "commingling" risk.

In Re LBIE the importance of viewing financial collateral arrangements "as a whole" was emphasised. In that case the mixing together of liabilities where the control requirement was held to be satisfied with liabilities where it was not satisfied proved fatal to the arrangement constituting a security financial collateral arrangement. This has prompted some to question whether other varieties of "commingling", for example of property constituting financial collateral with property that does not constitute financial collateral carries similar risk.

Although the ruling clearly indicates the unavailability of FCD protections in relation to "after-acquired" collateral, in no sense does the CJEU's judgment imply the legal invalidity of security interests that attach to after-acquired property (which is in any event a question of national law).

The potential unavailability of FCD protection to after-acquired property may be relevant to the risk assessments of banks that provide settlement overdrafts as an adjunct to clearing and settlement services offered to their custody clients. In many securities clearing and settlement systems such banks will incur irrevocable obligations to make cash payments or to deliver securities on behalf of their clients. Such obligations will be required to be performed on the settlement date but will often become legally and operationally irrevocable before settlement. In such circumstances settlement agents may look to rely on after-acquired property to mitigate the resulting credit exposures.

In some clearing and settlement systems, the unavailability of FCD protections to after-acquired property is not necessarily of concern to banks that incur settlement related credit exposures because of the availability of other protections (for example Part VII of the 1989 Companies Act and the Financial Markets and Insolvency Regulations in the UK and the protection for CREST settlement bank charges as well as, potentially, local implementation of the SFD in other EU member states). However, to the extent that settlement banks have counted on local implementation of the FCD as a source of legal rights to enforce against after-acquired collateral to cover credit exposures incurred prior to insolvency, then the CJEU ruling will be a cause for concern.

The second notable aspect of the CJEU judgment concerns its ruling that a depositor has to be "*prevented from disposing*" of the deposit in order for a bank to enjoy FCD enforcement rights over that deposit. The judgment itself sheds no real light on how this is to be achieved although the accompanying Advocate General's opinion offers more insight.[3] It says (emphasis added),

"*In the case of collateral provided in the form of cash deposited in an account, being in the control of the collateral taker must mean that the collateral taker not only has practical control over the account to which the collateral relates, but also has <u>the right to prevent withdrawal of cash by the collateral taker in so far as is necessary to guarantee the relevant obligations....</u> Article 2(2) of [the FCD] must be interpreted to the effect that the provision of financial collateral in the form of cash deposited in a bank account <u>requires the existence of a contractual clause</u> <u>conferring on the collateral taker the right to limit the use of monies deposited in that account in so far as is necessary to guarantee the relevant obligations</u>*."

Here, the verdict of the CJEU and in particular the Advocate General's opinion accords with the emphasis placed on legal control by Briggs J in Re LBIE. The emphasis on contractual rights to control withdrawals (as opposed to the creation of a "permanently locked box" containing collateral whose constitution does not change) is very much in line with the reasoning in Re LBIE. So, as far as English law on security financial collateral arrangements is concerned, nothing in the CJEU ruling upsets the *status quo*. Where a collateral provider has free and unfettered access to the collateral account rather than a restricted ability to access the account through agreed withdrawal and substitution mechanisms, the collateral taker is unlikely to have the requisite degree of possession or control.

The CJEU ruling does not change the position under English law that something less than "*Spectrum Plus*" levels of control (i.e. something less than a fixed charge) *can* satisfy the possession or control requirements of the Directive insofar as one is

[3] Opinion of Advocate General Szpunar delivered on 21 July 2016 - Case C 156/15 Private Equity Insurance Group SIA v. Swedbank AS.

concerned with the creation of a security financial collateral arrangement (rather than a title transfer arrangement).

What is perhaps more surprising in the present case is that neither the CJEU nor the Advocate General discusses the nature of the relationship between a bank and its depositor. Since a depositor loses any *in rem* rights in money deposited at its bank, the essential nature of the relationship is legally and economically identical to the one between parties to a title transfer financial collateral arrangement involving cash. While the clause at issue in the Latvian litigation refers to a deposit being "pledged", the nature of the disputed action taken by Swedbank was apparently to set-off mutual obligations rather than to "enforce" any proprietary interest in an intangible asset. It is unclear whether Latvian law characterises the relationship between banker and depositor any differently than English law[4] but it seems highly unlikely.

The CJEU ruling provides no further guidance on what a contractual clause in a deposit agreement should look like but one would hope that "flawed asset" clauses of the type that are routinely included in English law cash collateral and deposit agreements ought to satisfy the requirement. For example, a "deferred maturity" flawed asset clause causes a depositor's claim against its bank for repayment of the deposit to mature commensurately, as the depositor pays off mutual debts that it owes to the bank. Such a clause preserves the economic value of a bank's right of set-off and can stop a depositor from emptying its account before the bank has had an opportunity to exercise its right of set-off.

Question 2

Unsurprisingly, the CJEU held that the effective super priority enjoyed by financial collateral creditors in insolvency constitutes a proportionate and objectively justified derogation from the general principle of equality before the law set out in Article 20 of the Charter of Fundamental Rights of the EU. It is noteworthy that the CJEU addressed this question squarely in terms of EU law, even though the Latvian court's question was really couched in terms of national insolvency law. However, there is nothing in the judgment to suggest that the CJEU thinks the priority of financial collateral creditors offends *pari passu* principles of any Member State's insolvency law any more than it does the Charter of Fundamental Rights.

Question 3 to 5

The CJEU held that these three questions were inadmissible. Questions 3 and 4 were only of hypothetical interest (the Depositor being a corporation) and the CJEU affirmed its inability to rule on hypothetical questions of no importance to the relevant national litigation. The CJEU dismissed Question 5 on similar grounds.

Conclusion

This first ever ruling by the CJEU on the regime for financial collateral established by the FCD provides a mix of helpful confirmation on certain issues whilst failing to provide clarity on other important questions.

The judgment supports the prevailing English law interpretation of control, based primarily on the judgement in Re LBIE (although the latter case dealt with a more complex scenario involving securities rather than a simple cash scenario as in the present case).

However, the implications of the CJEU's ruling are potentially less helpful as regards "after-acquired" property. While the judgment does not imply the invalidity of security interests over after-acquired property, it clearly does indicate the unavailability of FCD protections (for example, the right to ignore insolvency moratoria) in respect of security over after-acquired property.

[4] Foley v Hill (1848) 2 HLC 28, 9 ER 1002

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