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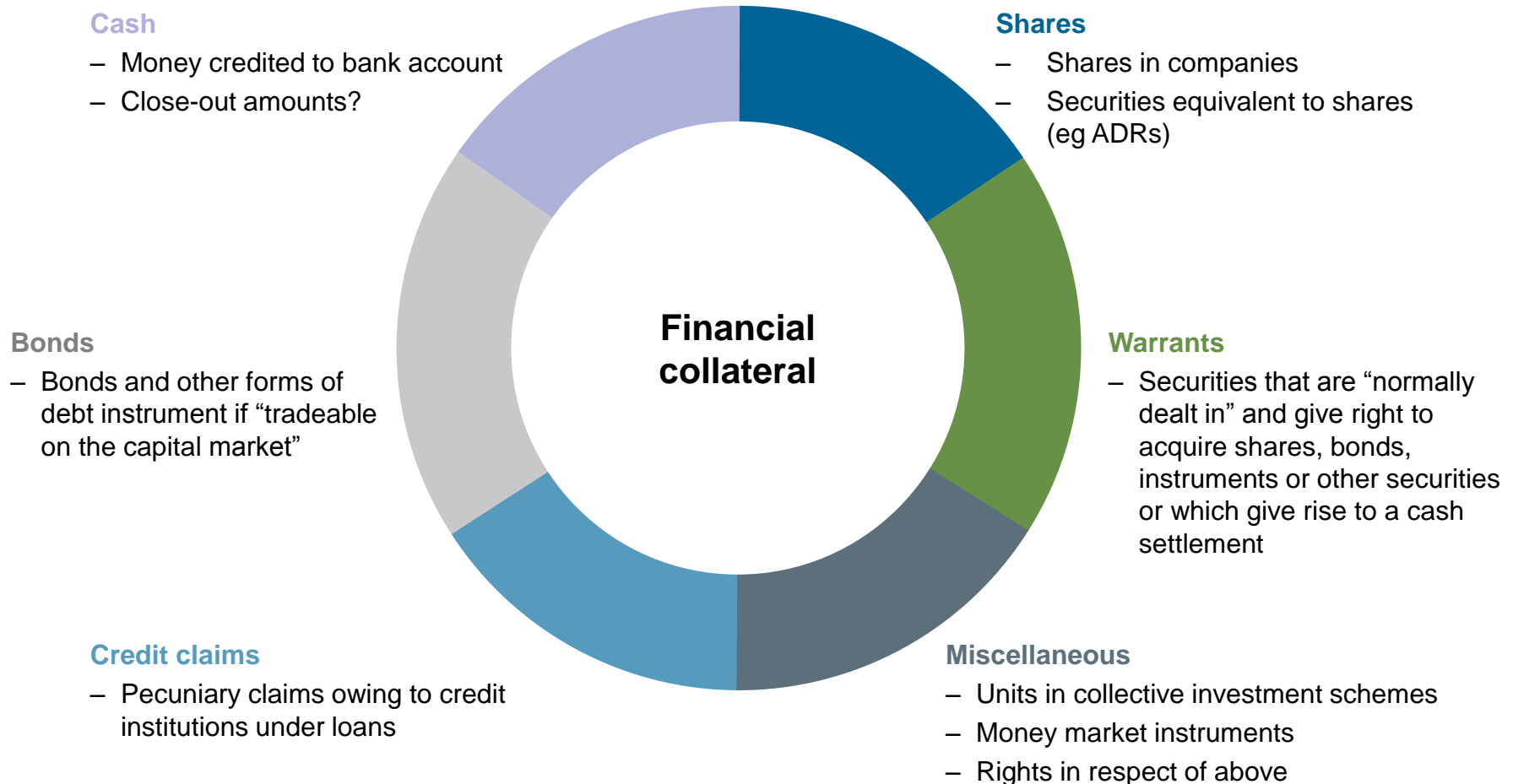
Secured Transactions Law Reform: Priority Rules and the Impact on Consumers
University of Leeds, School of Law - 6 January 2017



Specific Asset Classes: Financial Collateral

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Financial collateral: “cash” and financial instruments



A special regime implemented under European law



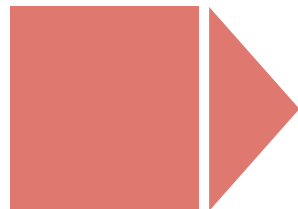
Financial Collateral Directive 2002/47/EC (the **FCD**)



Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) (the **FCARs**)



Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 (SI 2010/2993)



The Banking Act 2009 (Commencement No. 5) Order 2016 (SI 2016/598)

- Consumers are excluded!
- How would this regime be accommodated in a reform of the law of secured transactions?
- How will this regime be affected by Brexit?

Purpose of FCARs: to make it easier to create, maintain and enforce financial collateral arrangements

Enforcement

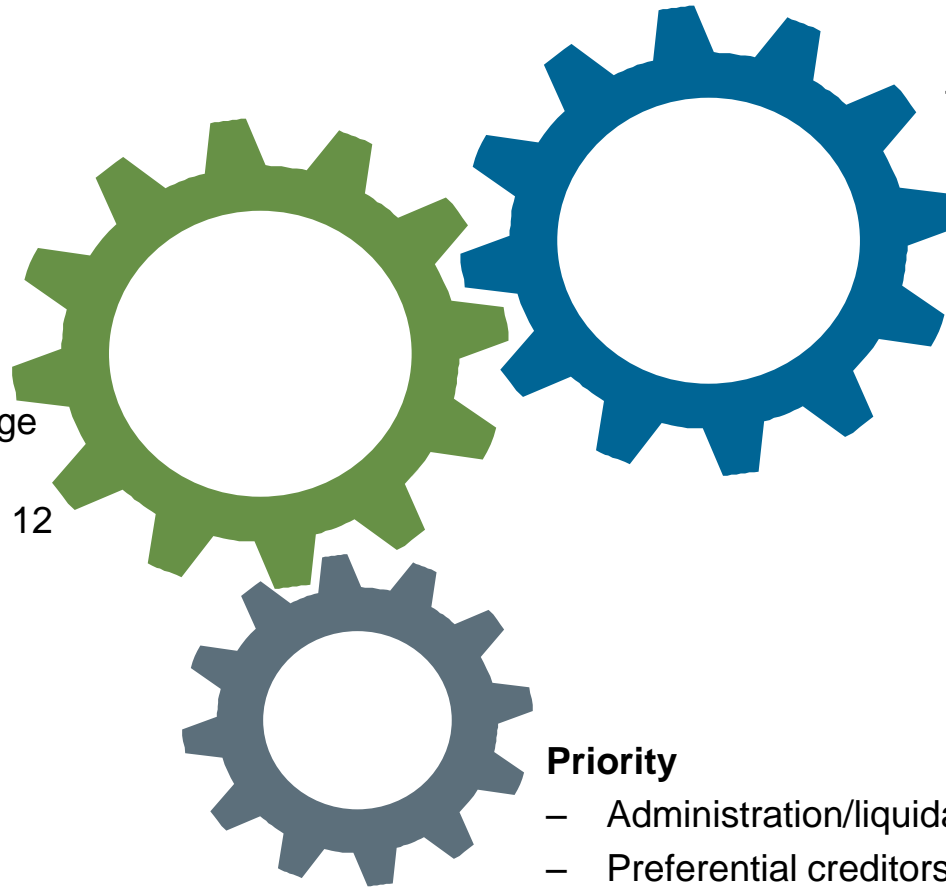
- Right to appropriate if express right/valuation mechanism
- Not caught by administration/small company moratorium
- No disclaimer/section 127/section 245 challenge
- What about section 238/239? Impact of Reg 12 FCARs

Registration

- No need to register against UK company (section 859A) and overseas company (section 1052)

Priority

- Administration/liquidation expenses
- Preferential creditors
- Ring-fenced fund (section 176A)



Purpose of FCD

“

balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding inter alia the risk of fraud

”

[Recital 10 FCD]

Types of financial collateral arrangement

Security FCA

Title Transfer FCA

Legal basis:

- Creation of fixed (or floating?) security interest over bank account and/or over financial instruments

- Transfer of title to financial instruments with right to reacquire title, subject to right of set-off on default
- Deposit of cash subject to right of set-off on default

Advantages:

- No registration requirement
- Can include right of collateral-taker to use (deal freely with) collateral
- Can include right of enforcing collateral-taker to appropriate
- Exempt from administration stay

- Even prior to FCARs
 - no perfection requirements
 - freedom of collateral-taker to use (deal with) collateral
 - not caught by administration stay
- Close-out netting in accordance with terms (even as to currency conversion)

Disadvantages:

- Uncertainties of FCARs may mean arrangement does not qualify
- Collateral-provider subject to credit risk on collateral-taker if right of use permitted and exercised

- Collateral-provider subject to credit risk on collateral-taker

Boundary issues

- To enjoy the benefits of the FCARs regime, it is necessary to satisfy certain conditions. Uncertainties in the drafting of the FCARs means that compliance can be difficult to judge.
- The necessary conditions:
 - Each party must be a non-natural person
 - The collateral provided must be “financial collateral” as defined in the FCARs
 - The obligations secured or otherwise covered by the arrangement must be “relevant financial obligations”
 - The arrangement must be “evidenced in writing”
 - The arrangement must fall within the definition of “security financial collateral arrangement” or the definition of “title transfer financial collateral arrangement”
 - Financial collateral must be delivered under the arrangement so as to be “in the possession or under the control” of the collateral-taker or a person acting on behalf of the collateral-taker
- What are the consequences of mistakenly falling outside of the FCARs regime by virtue of failure to comply with all of the above conditions?
- What is the consequence of including both financial collateral and collateral not within the definition of “financial collateral” under the same arrangement?

Are there any benefits of a security FCA over a 'normal' fixed charge?

	Fixed charge	Security FCA
Registration	<ul style="list-style-type: none"> – Required if UK company 	<ul style="list-style-type: none"> – Not required
Enforcement	<ul style="list-style-type: none"> – Caught by administration or, where relevant, small company stay – No right to use collateral – No right to appropriate – Section 245 challenge if recharacterised 	<ul style="list-style-type: none"> – Not caught by stay – Right to appropriate – Right to use collateral – No section 245 challenge if recharacterised as floating
Priority	<ul style="list-style-type: none"> – Priority over expenses, preferential claims and ring-fenced fund – Priority over judgment creditor/ subsequent fixed charges – Prevents further set-offs 	<ul style="list-style-type: none"> – Priority over expenses, preferential claims and ring-fenced fund, unless floating – Priority over judgment creditor/ subsequent fixed charges, unless floating – Prevents further set-offs, unless floating

Possession or control

“

Financial collateral is delivered, transferred, held, registered or otherwise designated so as to be *in the possession or under the control of the collateral-taker or a person acting on its behalf*; any right of the collateral-provider to substitute financial collateral of the same or greater value, withdraw excess financial collateral or collect the proceeds of credit claims until further notice shall not prevent the financial collateral being in the possession or under the control of the collateral-taker

”

[Definition of “security financial collateral arrangement” in the FCARs]

Possession

“

Possession of financial collateral in the form of cash or financial instruments includes the case where financial collateral has been credited to an account in the name of the collateral-taker or a person acting on his behalf... provided that any rights the collateral-provider may have in relation to that financial collateral are limited to the right to substitute financial collateral of the same or greater value or to withdraw excess financial collateral

”

[Definition of “possession” in the FCARs]

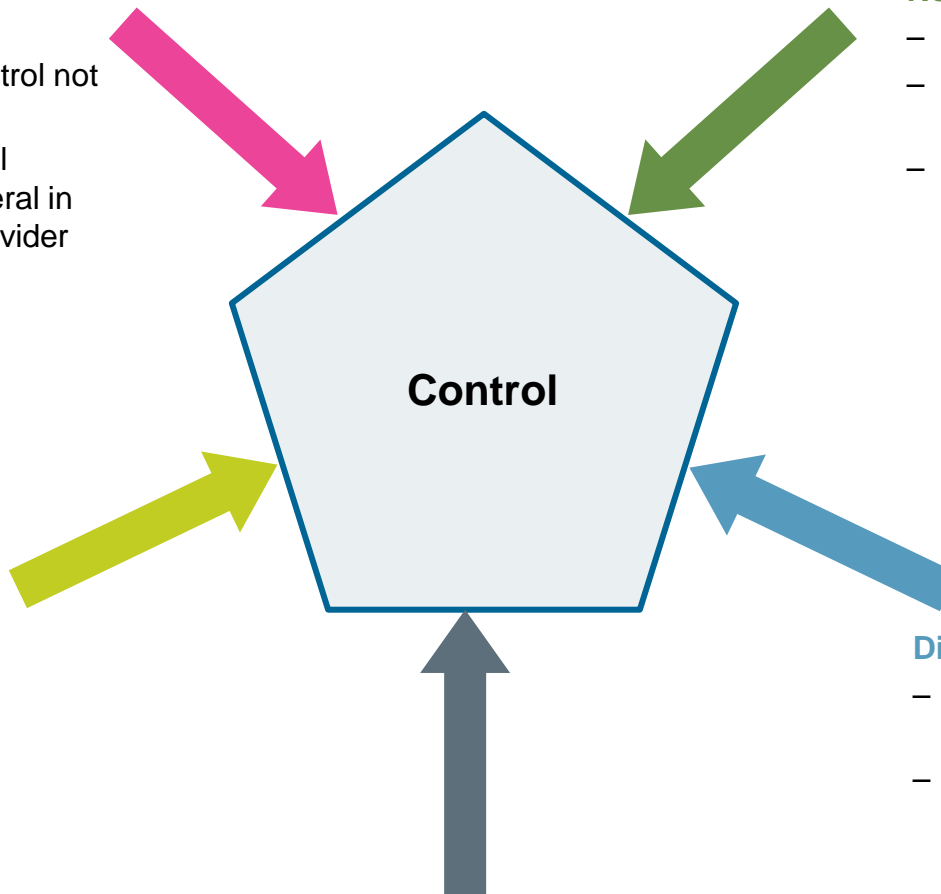
So what does this mean in practice?

Are legal and administrative control needed?

- administration/practical control not enough
- counsel considers that legal control not enough if collateral in an account of collateral-provider

No definition, limited case law

- *Gray* [2010] EWHC 1772
- *Re Lehman* [2012] EWHC 2997
- CJEU Case C 156/15, judgment dated 10 November 2016



Administration control

- where collateral-taker has custody of collateral

Dispossession is key

- rights of collateral-taker must go beyond that of custodian
- emphasis is on extent of residual risk of fraud by collateral-provider

Legal control

- collateral-taker must be able to refuse to hand collateral back

Is control test different for ordinary fixed charges?

Security FCA

- Two English cases on FCARs: *Gray* [2010] EWHC 1772; *Re Lehman* [2012] EWHC 2997
- Must have legal control, not just administrative control
- Most likely need administrative control as well to prevent fraud risk
- Collateral-provider permitted to withdraw excess (through how do you calculate?)/make substitutions
- May be able to use third party custodian to hardwire consents subject to fraud risk
- If document provides explicit rights, Briggs J says subsequent conduct not relevant (?)

Fixed charge

- Cases on book debts eg *Re Spectrum Plus Ltd* [2005] UKHL 41
- Must have legal control, not just administrative control
- Less clear whether must have administrative control
- Chargee must control/consent to substitutions/withdrawals of excess *Queens Moat House Plc* [2004] EWHC 868
- Hardwired consents problematic
- Subsequent conduct may vary security interest/indicate fixed charge is a sham

Goldplating: FCARs as secondary legislation may be invalid if beyond scope of FCD (*USA v Nolan* [2015] UK SC 63)

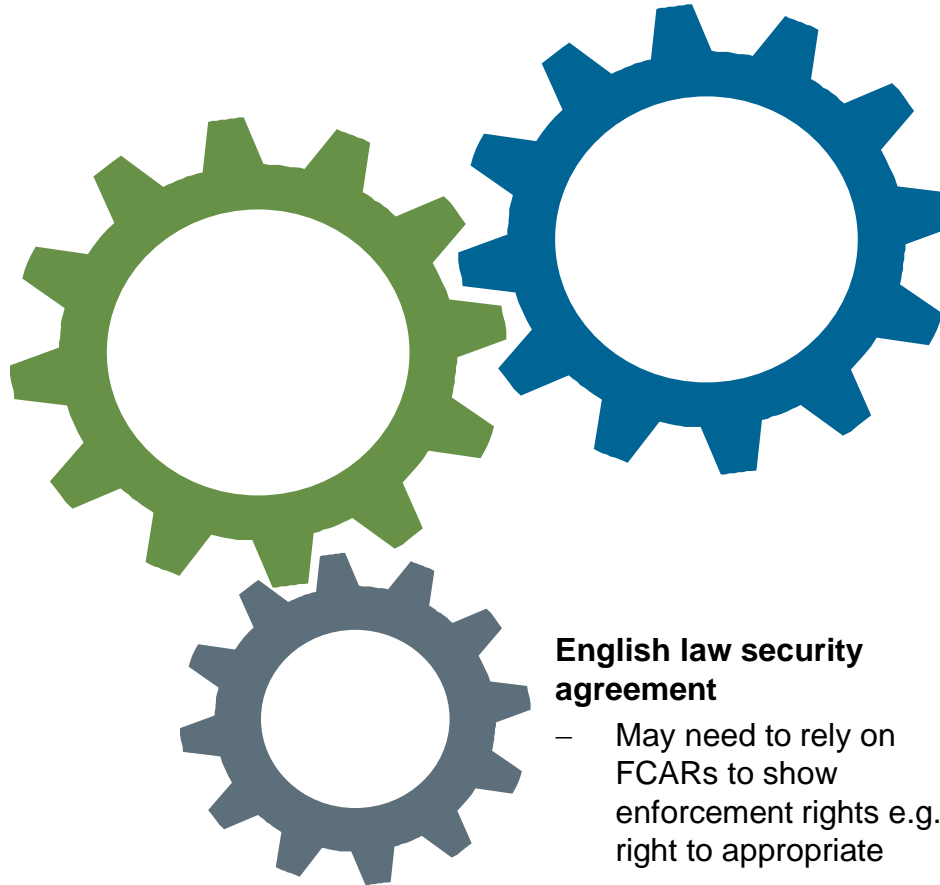
FCD		FCARs
<ul style="list-style-type: none"> – Each party must be non-natural person and at least one party must also be financial institution, CCP, central bank or public body 	Parties	<ul style="list-style-type: none"> – Each party must be non-natural person
<ul style="list-style-type: none"> – Money credited to an account or claim for repayment of money 	Cash	<ul style="list-style-type: none"> – As per FCD but also “sums due or payable to, or received between the parties in connection with the operation of a FCA or close-out netting provision”
<ul style="list-style-type: none"> – Not clear whether “negotiable on the capital markets” applies to shares 	Shares	<ul style="list-style-type: none"> – “Tradeable on the capital market” only applies to bonds and other debt securities

HMT can use powers under section 255 Banking Act 2009 to ensure FCARs are treated as having had effect despite any lack of *vires*

Cross-border aspects: FCARs will apply where...

Collateral located in England

- English court may wish to be satisfied that enforcement is consistent with English law
- Impact of Regulation 15A FCARs on section 426 request (but problems in determining whether foreign insolvency law provision is analogous to UK provisions covered by FCARs)
- Similar analysis re para 4, sch 1 CBIR



English chargor or English insolvency proceedings

- Switching off of registration requirements most relevant where English company
- Disapplying administration stay, priority provisions most relevant where collateral-provider is subject to English insolvency proceedings

English law security agreement

- May need to rely on FCARs to show enforcement rights e.g. right to appropriate

Areas of uncertainty – selected examples

What is financial collateral?

- FX warrants
- Private placement bonds requiring issuer consent to transfer
- Close-out amounts as “cash”

Possession or control?

- Impact of custodian liens
- Impact of set-off rights by custodian/banker
- Chargor’s voting rights
- Lack of control over dividends/coupons
- Lack of control over redemption proceeds
- Instructions to custodian and chargee’s right to block (administrative control)

Miscellaneous

- Does security need to be first ranking?
- What does “excess collateral” mean?
- Tainting risk if mixture of financial collateral/non financial collateral
- Valuation mechanism for appropriation

Questions?

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