Insolvency Bulletin

Spring 2013

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If there is a theme to the Spring edition of our bulletin, then it is probably about failing investment banks. The three main cases discussed concern Lehmans, Landsbanki and MF Global UK (which is famous for being the first institution to use the “new” Investment Bank Special Administration Regulations). For more on the MF Global case, you are recommended to read our very own Professor Rebecca Parry’s article which appears in the March 2013 INSOL electronic newsletter.

The Lehman case is fascinating in that it is really a resumé of much of the property and trusts law that you ever knew, or ought to have known, with some helpful stuff on the development of the Financial Collateral Arrangement Regulations thrown in. In this case, Mr Justice Briggs addressed a number of specific issues raised by the Administrators of Lehman Brothers International Europe on the basis of “agreed facts” for the purposes of the hearing. It was an impressive piece of consensual and sensible working on the part of all parties involved.

On the home front, we are delighted to remind you of our two forthcoming conferences:

- **Wednesday 12 June:** this event is being delivered jointly with the University of Leeds and will consist of a review of the European Insolvency Regulation. It will take place in Leeds and further details will be provided in due course.

- **Wednesday 11 September:** we will be holding our annual International Insolvency Conference here at Nottingham Trent University. Further details will be provided in due course.

So that’s it from us all for this term. Hope you enjoyed your bank holiday sledging...

With kind regards,

**Paula**

Paula Moffatt

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Where cross-claims existed between an Icelandic and a UK credit institution both of which were in insolvency proceedings in their respective EEA states, the UK credit institution could be wound up with the defences available to it under its own general law (including set-off) in accordance with the principles of universality and unity required by the EC Directive on the reorganisation and winding up of credit institutions.

Facts

Landsbanki Islands hf ("Landsbanki") and its subsidiary Heritable Bank plc ("Heritable") were both credit institutions for the purposes of the EC Directive 2001/24 on the reorganisation and winding up of credit institutions (the "Directive"). The Directive was implemented in the UK by the Credit Institutions (Reorganisation and Winding up) Regulations 2004 (the "Regulations"). Landsbanki was an Icelandic company and so a European Economic Area ("EEA") credit institution for the purposes of the Regulations and Heritable was a Scottish company and a UK credit institution for the purposes of the Regulations.

Both companies went into insolvency proceedings in October 2008. A winding-up board was appointed in respect of Landsbanki in Iceland and Heritable went into administration in the UK. Each company had made claims in the insolvency proceedings of the other. The issue arose as to how the decision of Heritable not to pursue its claims in the winding up of Landsbanki would affect the administration of Heritable.

The Landsbanki claims

Landsbanki had made three initial claims against Heritable: an £86 million revolving credit facility claim (the "LRCF claim"); a £50 million "subordinated debt claim"; and a £1,011 million "guarantee claim". A later claim under a master participation agreement (the "LMPA claim") was made for £17 million. The administrators of Heritable (the "Administrators") rejected the LRCF claim. The rejection was on the grounds that Heritable had claims against Landsbanki which equalled or exceeded the amount of the LRCF claim and so extinguished it: this set-off was achieved by the application of the Scots law principle of balancing accounts in bankruptcy. The Administrators also rejected the LMPA claim but accepted the subordinated debt claim and the guarantee claim. These claims were valued at nil on the grounds that there was no prospect of the relevant contingencies being satisfied.

Landsbanki subsequently appealed to the Scottish Court of Session against the decision to reject the LRCF claim. (They also appealed against the nil valuations, although the case only concerned the LRCF claim).

The Heritable claims

Heritable had submitted four claims in the winding up of Landsbanki: a £661 million revolving credit facility claim (the "HRCF claim"); a £234 million master participation agreement (the "HMPA"); a £7 million "swap claim"; and a £1 million claim for reimbursement of payments made by Heritable in connection with Landsbanki’s Icesave accounts in the UK (the "Icesave claim"). The claims were stated to be subject to set-off against amounts it owed to Landsbanki and were to rank as unsecured claims in Landsbanki’s winding up.

Landsbanki accepted part of the swap claim, but rejected the other claims.

The proceedings in Iceland

In February 2010, the Administrators objected to the decision to reject their claims. As Landsbanki had already commenced proceedings in the Court of Session, the Administrators asked to delay their objection proceedings until Landsbanki’s appeal had been determined. The winding up board of Landsbanki declined to accede to this request.

In March 2010, the Landsbanki winding up board referred the Administrators’ objections to the District Court of Reykjavik (the "District Court") under article 120 of the Icelandic Bankruptcy Act 1991 (the
“IBA”) (the “Objection Proceedings”). The Administrators sought a stay of the Objection Proceedings, but this was rejected by the District Court.

In August 2010, following the decision of the Lord Ordinary in the Scottish proceedings, the Administrators withdrew the Heritable claims (including the swap claim) from Landsbanki’s winding up. The Landsbanki winding up board issued a counterclaim (the “Counterclaim”) in the District Court seeking a declaration that the Heritable claims had been extinguished by article 118 of the IBA. Article 118 allows claims to be cancelled if they are not submitted to the trustee in bankruptcy within the prescribed time.

The Administrators successfully applied to discontinue the Objection Proceedings in September 2010. The Landsbanki winding up board unsuccessfully appealed against this decision to the Icelandic Supreme Court. The Icelandic Supreme Court did not rule on the Counterclaim because it was incompetent to do so.

The proceedings at first instance in Scotland
The Landsbanki winding up board had argued that the decision to reject the Heritable claims in the Icelandic proceedings was binding on the UK under Regulation 5(1) of the Regulations. This meant that the Administrators had no choice other than to conclude that Heritable had no claim against Landsbanki that could operate by way of set-off. This meant that the Administrators must pay the LRCF claim in full.

At first instance, the Lord Ordinary had held that, under the terms of the Directive, a ruling by the Landsbanki winding up board that was final and binding in Iceland should be given effect in the UK; and also that effect should be given to the extinction of a claim under Icelandic law where it had not been presented within the appropriate time. In his view, the decision of the Icelandic court would have effect in the UK as if it were part of the general law of insolvency in the UK and would have to be given effect in the administration of Heritable.

The appeal in Scotland
The Administrators appealed. At the Inner House hearing, the Landsbanki winding up board argued that the effect of the withdrawal of Heritable’s claims and discontinuance of the Objection Proceedings in Iceland was that its determination of those claims was final and binding under Icelandic law. This meant that Heritable’s claims had been extinguished as a matter of Icelandic law and had also been extinguished because they had not been submitted within the prescribed time.

The First Division held that, in accordance with the principles of universality and unity required by the Directive, Heritable was entitled, as a UK credit institution in insolvency proceedings, to be wound up with the defences available to it under its own general law. This was to protect the interests of its creditors. In particular, effect should be given to Regulation 22(3)(d) under which UK law could determine the conditions for invoking set-off in Heritable’s winding up.

Landsbanki appealed to the UK Supreme Court.

Decision
The Supreme Court unanimously dismissed Landsbanki’s appeal and affirmed the decision of the First Division’s interlocutor that a UK credit institution in insolvency proceedings should be wound up with the defences available to it under its own general law. Under the terms of the Directive, issues of set-off were to be determined in the home EEA state.

Comment
The issue before the Supreme Court was whether Icelandic law bound the Administrators: was the Heritable set-off claim against Landsbanki extinguished because it could no longer be maintained in the Icelandic winding up proceedings? Interestingly, there had been no previous case law on this issue. The judgment was delivered by Lord Hope. Although European cross-border insolvency proceedings generally fall within the EC Regulation on Insolvency Proceedings 1346/2000, under article 1(2), credit institutions are carved out of its scope. Instead, they are governed by EC Directive 2001/24 on the reorganisation and winding up of credit institutions (implemented in the UK as the Credit Institutions (Reorganisation and Winding up) Regulations 2004).
The Landsbanki winding up board had relied upon Regulation 5 to assert that its EEA (in other words) Icelandic insolvency measures had effect as if they were part of the general insolvency law of the UK. Thus the winding up of Landsbanki was an insolvency measure for the purposes of Regulation 5 and if this Icelandic insolvency measure rejected Heritable’s claims, then this decision must be automatically applied to insolvency proceedings in the UK. In this way, Heritable could not raise set-off as a defence to the claims Lansbanki was making against it.

The UK Supreme Court felt that this approach did not consider the wider implications of the Regulations or the Directive and, in particular, article 10 of the Directive, which was implemented in the Regulations as Regulation 22. Regulation 22 identifies the applicable law in the winding up of a UK credit institution and the matters to be determined under general UK insolvency law. These include the conditions under which set-off may be invoked. Issues of set-off are, therefore, to be determined in the home EEA state.

Lord Hope felt that there was much force in the argument presented by counsel for Heritable that to follow the approach taken by Landsbanki produced an “arbitrary and unprincipled outcome” (para 59). Logically, this approach suggested that if Heritable had been solvent and had chosen not to pursue a claim against Landsbanki, its claim would have been extinguished and could not have been raised even if Landsbanki pursued a claim against it in Scotland. Heritable could only avoid this outcome by maintaining a claim in the insolvency proceedings in Iceland even if its prospects of recovering anything were remote. Effectively, if one party were to get a quick decision, this would grant them universal priority. Such an effect would encourage forum shopping. It seems unlikely that this was the intention of the Directive.

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STRUCTURED FINANCE

In the matter of Lehman Brothers International (Europe) in administration and in the matter of the Insolvency Act 1986 [2012] EWHC 2997 (Ch)

Executive summary

Mr Justice Briggs dealt with a series of issues relating to standard form Lehman documents. The main issues considered related to the nature of the security interest created by Clause 13 of the Master Custody Agreement, whether it was valid and who were the beneficiaries of the security created by it. Broadly, it was construed as a valid floating charge in favour of LBIE.

In the summary that follows, each issue and its corresponding judgment have been dealt with in the order in which they appear in the case report. Only issues 1-14 have been covered in this report.

Facts

Lehman Brothers International (Europe) ("LBIE") was the European hub company of the Lehman Brothers group and went into administration in 2008. The administrators of LBIE sought directions from the court as to the interpretation, characterisation, validity and effect of what had been described as “security” provisions in two standard form documents. These standard form documents had originally been intended for use in transactions entered into by LBIE with third parties (so called “street” customers) but had later been used in transactions entered into between LBIE and another Lehmans’ affiliate, Lehman Brothers Finance SA ("LBF").

The US hub company, Lehman Brothers Inc ("LBI"), and 314 Commonwealth Ave Inc ("314 CA") were also parties to the proceedings.

The documents raised a number of issues of law and the parties had, for the purposes of the proceedings, agreed the facts. Mindful of the fact that any decisions made by the judge could become the subject of an appeal, the parties had asked the judge both to reach a judgment on each issue and to consider the alternative position in the event that he was wrong. In the summary that follows, each issue and the decision of the judge have been dealt with in the order in which they appear in the case report.
**Issue 1: the classification of the “general lien”**

LBIE had used a Master Custody Agreement (the “MCA”) to set out the terms on which it held property ("Property") belonging to its street customers as a custodian. Almost all of the Property consisted of intangibles, mainly in the form of bank accounts and dematerialised securities. Clause 13 of the MCA ("Clause 13") stated that the Custodian held the Property subject to a “general lien” until all the liabilities and obligations owed to LBIE by the customer (in this case LBF) had been discharged. If LBF failed to discharge its obligations after three days, LBIE was entitled to sell or realise the Property in order to satisfy LBF’s outstanding obligations. Clause 13 also stated that the general lien applied not only in respect of LBF’s obligations to LBIE, but also in respect of LBF’s obligations to other LBIE affiliates (including 314 CA).

The judge considered the nature of the security interest described as a “general lien” and three questions in particular. First, did it constitute a general lien as that term was understood as a matter of English law and, if so, was it capable of applying to intangible property? Second, was it properly characterised as a charge (in which case it could “bite” on both to tangible and intangible property)? Third, was it some other form of security interest capable of applying both to tangible and intangible property?

**Decision**

It was held that the Clause 13 term “general lien” did not mean a general lien as that term was understood as a matter of English law, since a general lien could apply only to tangibles and certificated securities.

It was held that the security interest created was equivalent to a charge. LBIE, as chargee, had a specifically enforceable right to have the Property appropriated to the discharge of a debt or other obligation. It was not inherent in the nature of a charge that, where the benefit of the charge was held for an obligation owed to a creditor other than the chargee (in this case LBIE was holding the benefit for its affiliates), that the chargee must be a trustee or fiduciary of that creditor.

The judge noted that there may be rare cases where security rights fall outside the recognised categories of lien, pledge, charge or mortgage in which a “flawed asset” may be created. In the present case, recourse to that characterisation would only have been necessary if the security interest had not been classified as a charge.

**Issue 2: were the rights to sell and apply the proceeds of sale part of the security interest or free-standing contractual rights?**

**Decision**

Having decided that the security interest created by Clause 13 was a charge, the judge inevitably concluded that the right to apply deposited monies in satisfaction of the relevant liabilities was a charge over deposited monies. He held, therefore, that a proprietary interest was created in the money and that this fell outside the ambit of the client’s property in LBIE’s liquidation.

He considered the position in the event that he was wrong about the security interest taking effect as a charge and that, in fact, it took effect as a lien. In his judgment, there would be a free-standing contractual right in respect of any intangible property that was not capable of being the subject matter of a lien. This was a commercially unrealistic conclusion, however, since money standing to the credit of an account is intangible and in this case the lien would capture almost none of the property held by LBIE as custodian. He would, nonetheless, have concluded that Clause 13 created a charge over the deposited money since it was a form of appropriation of assets towards the satisfaction of debts.

**Issue 3: if the judge was wrong on issues 1 and 2, (i) was LBIE prevented from enforcing the rights of sale and application contained in Clause 13; (ii) had those rights terminated; and (iii) if so, was it too late for LBIE to rely on those rights?**

On the judge’s analysis, issue 3 did not arise.
**Decision**

He answered the hypothetical questions as follows. In his consideration of (i), he rejected three submissions. First, he did not consider that the rights constituted “mutual dealings” for the purpose of the Insolvency Rules on set-off. Second, he did not consider that the invocation of the English courts’ co-operation and assistance in connection with the insolvency of a foreign company inevitably led to the application of English insolvency law and remedies, such as the *British Eagle* principle. The discretionary nature of the relief was made clear in Articles 21-23 of the UNCITRAL Model Law (incorporated into English law by Regulation 2 of the Cross-Border Insolvency Regulations). He doubted whether the *British Eagle* principle applied automatically to all contracts governed by English law but considered that no useful purpose would be gained by considering it. If the rights conferred by Clause 13 were, contrary to his view, purely personal, he did not think that LBF would be prohibited from invoking the *British Eagle* principle at some point. Third, he did not consider it necessary to deal with applicability of Article 20 of the UNCITRAL Model Law as this was an abstract argument. He concluded on points (ii) and (iii) that, even if purely personal, the rights of sale and application conferred by clause 13 were not terminated either by LBIE’s administration or by a letter sent from LBF to LBIE revoking any agency agreement. This meant that it would not be too late now for LBIE to rely on them.

**Issue 4:** if the security interest was a charge, was it (i) fixed or floating; (ii) in respect of LBF’s liabilities to LBIE only; and/or (c) if a charge in respect of LBF’s liabilities to other “Lehman Brothers entities” had the rights of sale and application been terminated?

**Decision**

The charge was a floating charge since Clause 13 permitted LBF a right to withdraw or substitute property pending crystallisation. On the analysis of the House of Lords in *National Westminster Bank v Spectrum Plus* [2005] 2AC 680 it could not be a fixed charge. The floating charge covered LBF’s liabilities both to LBIE and its affiliates. The rights of sale and application of the proceeds had not been terminated by LBIE’s administration or the letter from LBF revoking any agency agreement.

**Issue 5:** was there a charge on book debts?

Having established the existence of a floating charge it was not necessary to address this issue.

**Issue 6:** was the Clause 13 security interest saved from invalidity by the Financial Collateral Arrangements (No 2) Regulations 2003 ("FCARs")?

The first question that arose was whether the floating charge created by Clause 13 constituted a "financial collateral arrangement" for the purposes of the FCARs. There were three elements to the test: “bi-laterality”, “purpose” and “possession or control”. As the FCARs implemented Directive 2002/47/EC (the “Directive”), they needed to be interpreted in a manner consistent with the meaning and purpose of the Directive.

**Bi-laterality**

According to its recitals, the intention of the Directive was to promote cost-efficiency and financial stability across the EU where securities and cash were provided as collateral in security interest and title transfer structures, with a focus on bilateral financial collateral arrangements. To improve legal certainty, Member States were required to ensure that certain provisions of insolvency law did not apply to such arrangements, particularly where they would interfere with, for example, bilateral close-out netting arrangements. The Directive sought to limit the formal requirements for perfecting financial collateral arrangements and this included a requirement that perfection should not be made dependent upon registration or certain other formalities. There was recognition that a balance was required between market efficiency and the risk of fraud.

Counsel for LBF submitted that the Clause 13 security was not subject to a financial collateral arrangement because it was multi-lateral in that it created security for LBIE’s affiliates as well as LBIE.

**Decision**

Although the recitals to the Directive referred to the concept of “bi-laterality”, the Articles and the FCARs did not. The judge held that it was not intended to confine the scope of the Directive to agreements between only two parties and this was also the case with the FCARs. The arrangement
created by the MCA did not fall outside the definition of “security financial collateral arrangement” by reason of any multi-lateral rather than bi-lateral aspect of it.

"Purpose"
The FCAR definition of “security financial collateral arrangement” states that its purpose “is to secure the relevant financial obligations owed to the collateral-taker”. The purpose set out in the FCARs was not set out in the Directive.

Counsel for LBF submitted that the attempt to secure the financial obligations owed to LBIE’s affiliates took Clause 13 outside the restricted scope of the purpose test.

Decision
The judge concluded that the drafting should be treated as descriptive rather than restrictive. The MCA created security over LBF’s property to secure debts owed by LBF to LBIE and so qualified as a security financial collateral arrangement. He held that it would be contrary to the Directive for the regime to be dis-applied to Clause 13 simply because it constituted security for debts owed to LBIE’s affiliates.

Possession or control
The definition of “security financial collateral arrangement” under the FCARs requires the financial collateral to be “delivered, transferred, held or otherwise designated so as to be in the possession or under the control of the collateral-taker or of a person acting on the collateral-taker’s behalf”. Counsel for LBF submitted that the requirement to demonstrate possession was in addition to a requirement that the collateral be “delivered, transferred, held or otherwise designated”.

Decision
The judge analysed the manner in which the “possession or control” concept was introduced into the Directive and FCARs and its subsequent meaning and effect. He held that only those forms of delivery, transfer holding or designation which actually led to the result that the collateral was in the possession of or under the control of the collateral-taker would qualify for inclusion within the regime. He agreed, broadly, with the possession and control requirement identified by Vos J in Re F2G Realisations Ltd: Gray v GTP Group limited [2011] 1 BCLC 313. He held that, the collateral-taker had to have sufficient possession or control of the collateral so that the collateral-provider could be described as having been “dispossessed” of it.

In this case, LBF retained uncontrolled rights of recall and disposal of the property; LBF could do what it liked with the property regardless of its liabilities to LBIE’s affiliates. In this way, the security rights conferred by the MCA fell short of a qualifying security financial collateral arrangement.

Retroactivity
The MCA was executed four months before the FCARs came into force on 26 December 2003. Counsel for LBI submitted that, in view of this, the FCARs did not apply to the MCA.

Decision
The judge held that the FCARs were not retroactive and did not apply to any security interest created before the 26 December 2003. The charges created by the MCA did not constitute security financial collateral arrangements for the purposes of the FCARs.

Issue 7: if the answer to issue 6 was wrongly decided, would section 53(1)(c) of the Law of Property Act 1925 apply so that the absence of writing rendered the disposition ineffective?

Section 53(1)(c) requires a disposition of an equitable interest or trust to be in writing. It was common ground that the MCA was signed on behalf of LBF, but counsel for LBI submitted that there could be property charged in favour of LBIE under a similar form of agreement made between some other Lehman companies which was not signed by the chargor.
**Decision**

It was held that, as between LBIE and LBF, the MCA was signed on LBF’s behalf so that there was no issue under section 53(1)(c). In the case of an equivalent written but unsigned agreement between LBIE and an affiliate, section 53(1)(c) could apply where the beneficial interest subject to the charge was held by the chargor prior to the agreement being made. If, however, LBIE acquired title to the relevant dematerialised security (whether legal or equitable) from a vendor to the chargor so that the charge under the agreement arose simultaneously with the transfer of title, then section 53(1)(c) had no application (Vandervell v IRC [1967]2AC 291).

**Issue 8**: if the security interest took the form of a floating charge, was it liable to be declared invalid under section 245 Insolvency Act 1986?

**Decision**

The floating charge security under the MCA had not been made at the “relevant time” for the purposes of section 245. This was not the case, however, with a second document, the “STB”.

**Issue 9**: did the rights created by Clause 13 extend to an affiliate’s client money entitlements?

The judge considered that whether any specific property was or not was held by LBIE as custodian under the MCA was a question of fact and beyond the scope of the judgment. Similarly, the issues as to whether the Clause 13 security interest affected (i) money actually held by LBIE as custodian as well as (ii) money which it ought to have held as custodian were also beyond the scope of this judgment.

**Issue 10**: did the STB supersede the MCA, so that the security interest created by the Clause 13 was no longer enforceable?

**Decision**

The judge held that it did not. The security rights granted to LBIE by the STB were in the nature of a floating charge, but did not constitute a financial collateral arrangement within the meaning of the FCARs. It was of no consequence that LBIE did not register the floating charge created by the MCA since no registration was required for a company neither incorporated nor having a place of business in the UK.

**Issue 11**: certainty of object – were the words “Lehman Brothers entities“ sufficiently certain for the purposes of establishing a class of beneficiaries, or should they be disregarded?

Applying the test from McPhail v Doulton [1971] AC 424 at 456, the term was conceptually certain.

**Issues 12 -14**: did Clause 13 (i) create a trust or fiduciary power in favour of “Lehman Brothers entities”; or (ii) confer rights by virtue of the Contracts (Rights of Third Parties) Act 1999 “Lehman Brothers entities”?

The judge referred to the “business efficacy” test set out in Underhill and Hayton’s Law Relating to Trusts and Trustees 17th Ed para 8.1 which stated that: “in the business context, it is well recognised that the unthinking identification, whether by implication or otherwise, of a trust relationship between business entities runs the serious risk of producing results contrary to the parties intentions and contrary to ordinary business common sense”. He held that an attempt to imply that a trust or other fiduciary obligation was owed by LBIE to its affiliates in relation to the charge or security interest created by Clause 13 failed the “business efficacy” test and would be absurd in the context of the ordinary management of the Lehman group’s business. LBIE and its affiliates were not equal beneficiaries in relation to the Clause 13 security rights.

No rights were conferred by the Contracts (Rights of Third Parties) Act 1999.

**Comment**

This case is fascinating for the discussions around property and property rights. It is also impressive because it is clear that all the parties involved in the case have worked consensually and effectively to try to find answers to difficult questions and Mr Justice Briggs praised all the lawyers involved for their help in presenting the case with such clarity.
In his consideration of the nature of the “general lien”, Mr Justice Briggs invited counsel to consider whether the English law concept of a general lien should be extended to include intangibles. He found an analogy in the approach taken by the House of Lords in Re BCCI No. 8 [1998] AC 214 and Lord Hoffmann’s remarks on p228 in which his Lordship had said “In a case where there is no threat to the consistency of the law or objection of public policy, I think the courts should be very slow to declare a practice of the commercial community to be conceptually impossible…”. Counsel chose not to take up the invitation, but it is an approach that is worth commenting on as it may assist the appellate courts in any future discussions of these matters.

The analysis of the FCARs is also instructive. The detailed discussion of the travaux preparatoires and the recitals to the Directive is a useful reminder of what the Directive sought to achieve and why. The fact that Mr Justice Briggs addressed the question of “possession and control” raised in the Gray case afresh was also useful: Gray had not had the benefit of the detailed argument that was available to the court in the present Lehmans case and had been criticised for concluding that the collateral-taker was required to have legal control over the financial collateral and for the fact that the judge had taken a narrow view of “possession” concluding that it was irrelevant to intangibles. This judgment was considered to be so restrictive that it robbed the FCARs of their effect. (The FCARs were subsequently amended in April 2011 and the term “possession” defined in such a way as to apply to financial collateral). Mr Justice Briggs took the view that both “possession” and “control” meant something more than the collateral-taker simply having custody of the financial collateral and, broadly, agreed with the analysis in Gray other than the irrelevance of possession to intangibles. From this, he concluded that the collateral-provider had to be shown to have been “dispossessed”.

The Financial Markets Law Committee is concerned at the lack of certainty in the term possession2 and summarises the position as follows: the FCAR definition has been judicially disapproved, but if the ordinary meaning of possession is used “it is unclear what rights may reside with the collateral-provider [e.g. receiving income or voting] without this preventing the collateral-taker from having “possession” of the collateral”.

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2 See Financial Markets Law Committee Analysis of uncertainty regarding the meaning of “possession or … control” and “excess financial collateral” under the Financial Collateral Arrangements (No. 2) Regulations 2003, December 2012 at para 2.7 available at www.fmlc.org

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The Administrators of MF Global (UK) Limited v Attestor Value Master Fund LP and Schneider Trading Associates Limited (as Respondents and as representatives) and the Financial Services Authority as an Interested Party [2013]EWHC 92 (Ch)

Executive summary

The hindsight principle is not applicable to the determination of claims to client money for the purposes of a distribution under CASS 7A.

Facts

MF Global UK (“MFG UK”) was the English subsidiary of MF Global Holdings Ltd, a company incorporated in Delaware. The MF Global group carried on business as an international broker-dealer in the financial markets, operating mainly out of London and New York through MFG UK and MF Global Inc respectively. In October 2011, both these companies and others within the group went into formal insolvency proceedings. Administrators for MFG UK were appointed under the Investment Bank Special Administration Regulations 2011.

MFG UK acted as an intermediary broker for the European business of the MF Global group and provided various services, including clearing services. MFG UK entered into bilateral transactions with customers and many of these required clients to provide margin. The margin was provided on the day that the trade was made and, while it was open, on a continuing basis to reflect the underlying risk. In this way, the margin requirement would be increased or decreased so that sums were debited or credited to clients’ accounts.

Under Rules 7 and 7A of the Client Assets Sourcebook (“CASS”) section of the Financial Services Authority Handbook (the “FSA Handbook”), investment firms are required to segregate client money and hold it on trust. In the event of the firm’s insolvency the money must be distributed amongst the clients pro rata, in accordance with their entitlements. This requires that the value of a client’s
entitlement is established at the date when the obligation arises, being the primary pooling event (“PPE”).

In seeking to apply the CASS requirements, the issue arose as to how a client’s entitlement to the funds available should be calculated on the administration of MFG UK. There were two possible ways of valuing a client’s open position on trades made with the firm: first, by reference to market value as at the PPE or second, by reference to the prices at which the trades were subsequently closed out, whether at the contractual settlement date or at an earlier date in accordance with the default provisions.

The Administrators sought a direction from the court as to which approach should be taken. Two respondents were joined to proceedings to represent the clients of MFG UK who would gain from one or other of these approaches (the client groups being the “Attestor” group and the “Schneider” group). The Attestor group’s claims would have been valued more highly if the open positions had been valued by reference to market value as at the PPE. The Administrators had calculated that this valuation method would have improved the group’s cumulative claims by $59 million. In fact, their positions had been closed out at prices lower than their market values at the PPE at a cumulative sum of $450 million. The Schneider group’s claims had been cumulatively valued at $244 million using the closed-out prices method. The Administrators had calculated that this would be reduced by $27.9 million if calculated by reference to the market value at the PPE.

Counsel for the Attestor group submitted that the matter was governed by the interpretation of CASS Rules 7A.2.4R and 5R. The constituent elements of the calculation of a client’s entitlement were the client’s individual client balance and its client equity balance. The latter was determined by the notional closing out of all open positions on the client’s margined transactions at, according to the definition in the FSA Handbook, “the closing or settlement prices published by the relevant exchange or other appropriate pricing source”. This meant that it was not possible to substitute a different figure calculated on the basis of the price at which open positions were, in fact, closed out.

This approach was supported by Counsel for the FSA who considered that the valuation of the client equity balances was made on the basis of an assumed close out. The valuation was not made on a contingent basis, which meant that hindsight was not relevant. The CASS rules applying to client money operated independently of the general law of insolvency as they were concerned with the pooling and distribution of trust assets.

Counsel for the Schneider group submitted that, at the time of a PPE, a client had two sets of rights. The first was a personal right under the contract to be settled which, in the case of open positions at the time of a PPE, would be a contingent claim. The amount to be paid would depend upon market movements and the close out price of the contract. The second right was a proprietary right to participate in the distribution of client money in accordance with CASS 7A. Where a PPE arose as a consequence of a liquidation or administration, the calculation of a client’s personal claim under the transaction contract would be subject to the provisions of insolvency law. The application of general insolvency law would include the application of the hindsight principle. This meant that, if the contract closed out between the commencement of insolvency proceedings and the date of a distribution to an unsecured creditor, the amount payable to the client would be treated as a claim as at the date of the insolvency event. In addition, the client money entitlement would be calculated in accordance with CASS 7 and 7A.

Decision

It was held that the hindsight principle did not apply to the determination of claims to client money for the purposes of a distribution under CASS 7A.

The submissions of Counsel for the Schneider group echoed the submissions made in the case of Lehman Brothers International (Europe) v CRC Credit Fund Ltd [2012] Bus LR 667 which had been rejected by the Court of Appeal and the majority in the Supreme Court. Although in the Lehman case the absence of a definition of “client money entitlement” had caused the main issue on which the Supreme Court was divided, the majority was clear as to its meaning as “a reference to the contractual entitlement to have money segregated for the client”.

The decision in Lehman was clear authority that the amount of the client money entitlement of each client was to be ascertained by reference to their individual client balances and client equity balances
which would be calculated in accordance with Annex 1 to CASS 7 and would include mandatory set-off
between the two balances.

There was no indication in the CASS rules that the hindsight principle should be applied. That principle
was relevant where an estimate of a claim was required to be made at a particular date, assessing the
chances of the contingency occurring and the likely amount of any claim. The process in CASS 7 and
7A was quite different in that it involved a notional valuation of open positions as at the PPE date.
In his judgment, the FSA had taken a policy decision to adopt the same basis for the calculation of
close-out positions as applied to daily reconciliations. This was understandable for reasons of
consistency, simplicity and speed.

Comment

As Professor Rebecca Parry wrote in her recent INSOL Highlight Article: “Rejection of a “hindsight”
approach to the calculation of client money claims in MF Global UK”, this case is one in a line of cases
which establishes that CASS operates as a code in itself and that it is not necessary to look at the
general law to fill in the gaps. The difficulty posed by the CASS rules is that they have turned out to be
insufficiently clear when it comes to their practical application. It is this lack of clarity that has led to
litigation as to how the gaps should be filled. One possible solution to the problem of valuing clients’
claims was the application of the hindsight principle.

3 See March 2013 INSOL electronic newsletter

The decision in MF Global UK to reject this principle is consistent with first instance decisions in Re
Global Trader Europe Ltd [2009] EWHC 699 (Ch) and Lehmans (the hindsight principle was not
considered before the Supreme Court in the Lehmans case).

Expert evidence was offered for the Schneider group to suggest that mark-to-market values might not
provide good evidence as to the market value of open positions as at the PPE as there were likely to be
a number of pricing uncertainties or inaccuracies in any calculation. The judge took the view that there
was no perfect system for establishing the figures at which open positions would close-out on the PPE
date, but concluded that the policy approach adopted by the FSA was perfectly reasonable.

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DIRECTORS DISQUALIFICATION

In the matter of the Company Directors Disqualification Act 1986 between Stephen Matthew
Hicks and Joanne Elizabeth Ponting and the Secretary of State for Business Innovation and
Skills – Claim Nos. 8855 and 8856 of 2012 (unreported)

Executive summary

Following the discontinuance of disqualification proceedings brought by the Secretary of State against
the directors of an insolvent company, disqualification undertakings given by two other directors who
were not party to the proceedings were released.

Facts

Farepak had operated a Christmas savings scheme under which customers could spread their
Christmas savings over a year. Money was paid by customers to “agents” who then forwarded it on to
Farepak. In return, customers would receive shopping vouchers from Farepak which could be
redeemed at various retailers, such as Argos.

The money paid to Farepak by the agents was passed to its parent company European Home Retail
(“EHR”) and used as working capital. Farepak was not contractually obliged to segregate the money
paid to it by its customers and did not, in fact, do so. In 2005, Farepak and EHR realised that they
could not pay their voucher supplier the several million pounds it was owed. The companies’ bank
refused to support it and, in 2006, Farepak went into administration, owing its customers and agents
£37 million.

In 2011, disqualification Proceedings were started against the Directors of Farepak and EHR under
section 8 of the Company Directors Disqualification Act 1986.
The case brought by the Secretary of State for Business Innovation and Skills ("SoS") against the directors was that the solutions they pursued to resolve the funding crisis were too little too late. The claimant directors offered disqualification undertakings which were accepted by the SoS, but the proceedings continued against the remaining defendants. The proceedings were subsequently discontinued by the SoS following serious criticism by the judge of the SoS’s conduct in the proceedings.

Although the claimants had offered disqualification undertakings they had, nonetheless, felt unable to accept the allegations and, after agreeing the period of disqualification, had proceeded to reach agreement with the SoS as to the agreed statement of facts forming the schedule to the undertaking. Both claimants recognised that they had fallen short of the standard expected of directors in not challenging matters more forcefully with their fellow directors.

Counsel for the claimants asked the court to exercise its discretion to release the claimants from their undertakings on public interest grounds since the disqualification proceedings against the other directors had been dropped. The SoS consented in principle.

**Decision**

The claimants were released from their undertakings on public interest grounds.

**Comment**

The Farepak story caused real hardship for a number of people who had very little in the first place. Efforts were made at the time to try to establish a trust in favour of the customers, but the facts simply did not support it as the arrangements were, essentially, contractual. Some amounts paid during the period after Farepak had announced its difficulties were held on constructive trust, but this had to be established on the facts and so did not help everyone ([Dubey v Revenue and Customs Commissioners](http://www.bis.gov.uk/insolvency) [2008] BCC 22).

It was not surprising that the directors were pursued in this case. And yet despite its high profile, the litigation failed and the conduct of the SoS was criticised. It seems fair, therefore, that the two directors who had given disqualification undertakings (and who were no more culpable than the other directors) should have been released.

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4See the Insolvency Service's "Review of the Disqualification Proceedings Taken in the Case of European Home Retail and Farepak Food and Gifts Ltd" December 2012 available at [http://www.bis.gov.uk/insolvency](http://www.bis.gov.uk/insolvency)