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Butterworths Journal of

International Banking and Financial Law

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KEY POINTS
- The Lehman Protocol in practice turned out to be an extremely valuable restructuring tool.
- The EU Regulations and the Model Law on Cross Border Insolvency are a major step in the right direction but are incomplete and inadequate for another failure of Lehman's proportions.
- The default to territorial protections of local creditors is inefficient from a group perspective.

Spotlight

Author Hon James M Peck

Cross-border observations derived from my Lehman judicial experience

This article recounts the history of the Lehman Protocol and makes some useful observations.[1]

Being able to seek prompt and effective relief under a flexible insolvency regime is an essential corollary to entrepreneurial risk taking. I alluded to this concept during the historic hearing to approve the sale to Barclays Capital on 19 September 2008 when I noted the awesome power that comes with being a bankruptcy judge whose job is to preside over a case of global importance.

Lehman is perhaps the best example I can identify of the remarkable utility of Chapter 11 relief. Chapter 11, even for more mundane cases, is an essential part of the business life cycle in the United States. It allows for the orderly sale of operating businesses and provides a specialised forum for the resolution of disputes arising out of bankruptcy cases. As I reflect on the Lehman Brothers experience, I believe that the US bankruptcy system functioned well at a time of crisis to maximise creditor recoveries and to help mitigate systemic risk. This was the biggest test ever of Chapter 11, and in my view a huge success. A sign of that success is the recent disclosure that creditor recoveries are now estimated to exceed $90bn and that some Lehman affiliates may even be solvent entities.

The Lehman filing was for me a life changing event. I found myself, by the accident of random case assignment, managing an insolvency of epic proportions in which the whole world was watching my every judicial move. We all felt it: this was the big one – the most frightening financial panic of our lives. Lehman's sudden and shocking global insolvency was what might be termed a "black elephant" – a highly unlikely "black swan" event that also was a proverbial "elephant in the room", a leading international investment bank that in the months following the near failure of Bear Stearns was being punished by market participants until its spectacular demise became all but unavoidable without a willing merger partner or a bailout.

COMPLEXITIES OF GLOBAL INSOLVENCY

As a consequence of presiding over Lehman's bankruptcy cases, I have seen the complexities of a massive global insolvency on a first hand basis. My pragmatic experience reveals the limits of modified universalism. When a global enterprise falls apart, creditors and their representatives are motivated by self-interest and care little about the theoretical advantages of collective action. Many of the benefits of a Chapter 11 process, thus, can be lost when the corporate group includes members that are subject to the insolvency laws of multiple jurisdictions.

Despite this tendency of stakeholders to favour their own territorial approaches to resolution, I recognised early on that there was a manifest need for a global way to address such a massively complicated cross-border problem. I attended a programme organised by The World Bank in January 2009 and presented a speech there. Insolvency experts had come from all over to consider the adequacy of existing insolvency regimes and whether they were capable of resolving the counterparty risks associated with significant non-bank financial institutions.

As a direct consequence of those meetings six years ago, I came to realise the magnitude of this insolvency problem: Lehman was a huge case in my court but also was at the centre of an unregulated group of foreign mega cases in many other jurisdictions around the world. I saw the need for a multi-lateral cross-border protocol of co-operation to tie together and provide structural connections for these multiple insolvency cases. I started to advocate a collective approach to the shared goals of increased transparency, better communication, improved co-operation, creative compromise and systemic co-ordination needed to resolve and unwind the tangled mess of intercompany claims within the Lehman corporate family.

As I saw things, I was presiding over the main case in a corporate enterprise group, and I was determined to exercise case management leadership for the good of creditors wherever they might be located. These stakeholders of the integrated business that,before the bankruptcy had been an operating and vibrant Lehman Brothers, were now scattered everywhere that this investment bank had operations

"I saw the need for a multi-lateral cross-border protocol of co-operation to tie together and provide structural connections for these multiple insolvency cases"

– and that was most of the planet. To focus inwardly and disregard the intercompany claims of foreign affiliates would make it extremely difficult to develop a confirmable plan in the US.

A CROSS-BORDER INSOLVENCY PROTOCOL

The facts of the Lehman collapse were daunting. Beginning in September 2008, over 80 of Lehman's direct and indirect foreign subsidiaries became subject to insolvency, administration, liquidation, rehabilitation or receivership proceedings commenced in 16 foreign jurisdictions, including common law and civil law jurisdictions in Europe, Asia and offshore locations. With the aim of creating a set of non-binding procedures that might encourage information sharing and possible claim allowance and reconciliation among these far flung insolvency cases, I proposed and the Debtor drafted an ambitious cross-border insolvency protocol that would allow for and encourage the co-ordination of these foreign proceedings.

designed to advance the objectives of the protocol.

Cross-border procedures on such a broad scale never before had been attempted. Earlier protocols, including the pioneering one developed in the Maxwell case in 1996 and approved by Judge Tina Brozman and Lord Hoffmann, were bilateral arrangements. Maxwell still represents an outstanding achievement in which a US plan of reorganisation and a UK scheme of arrangement were interdependent and constituted an integrated approach to realising value for creditors in both jurisdictions.

THE LEHMAN PROTOCOL

The Lehman Protocol was less than that but also more. It was designed intentionally to promote dialogue among creditors and their representatives. The hope was that transparency and growing trust would advance good faith negotiations leading to a comprehensive consensual plan of reorganisation. The protocol did not limit or encroach upon the authority of any

> "In retrospect, the order approving the protocol in June 2009 may be the most important precedent from Lehman for international insolvency practitioners"

In retrospect, the order approving the protocol in June 2009 may be the most important precedent from Lehman for international insolvency practitioners. It laid out a set of procedures for dealing with interconnected claims in multiple insolvency cases. Experience has shown that the protocol worked well in practice to promote compromise, and similar concepts are adaptable to, and potentially useful in, other corporate group settings.

Official representatives signed the protocol representing Lehman affiliates in Australia, the Netherlands, the Netherlands Antilles, Hong Kong, Germany, Luxembourg, Singapore, Switzerland, and the US. In addition, estate representatives from Japan and Bermuda, participated in activities and meetings

foreign representative or the jurisdiction of any foreign tribunal. It was a non-binding structure for building bridges – lots of them.

The Lehman Protocol aimed to:

- encourage communication and data sharing among the various Lehman administrations;
- permit insolvency representatives to appear and be heard at meetings in other jurisdictions;
- facilitate sharing of information among courts, insolvency representatives, and committees;
- preserve assets and maximise recoveries in each jurisdiction;
- reconcile claims and adjust distributions to ensure that creditors would not receive multiple recoveries on the same claim from various jurisdictions; and
- maintain the independent sovereignty and authority of all tribunals.

These ambitious goals were mostly aspirational in nature. The protocol served as a model for collective action to compromise disputes and enhance creditor recoveries. I was disappointed early in the proceedings by the decision of the UK administrators not to enter into the protocol. From my vantage point, the proposed arrangements were highly desirable from a case management perspective and were meant to be risk free for all parties. I did not grasp why the administrators were unwilling to sign the protocol and chose to act on their own. I will admit to having been annoyed.

Since my retirement from the Bench last year I have had the chance to speak informally with the administrators and to learn more about their priorities and concerns. They have assured me that their reticence with respect to the protocol was a consequence of their faithful and diligent exercise of fiduciary duties owed to Lehman Brothers International (Europe) (LBIE) stakeholders, not a rejection of an international approach to case management.

As it turns out, the LBIE administrators, working independently of the protocol, proceeded nonetheless to engage with parties in the US and elsewhere. Given the multi-jurisdictional character of the Lehman insolvencies, such cross-border engagement was unavoidable. They negotiated a variety of meaningful settlement agreements including a multi-billion dollar agreement between Lehman Brothers, Inc and LBIE that was approved by me and by Mr Justice David Richards in separate judicial proceedings. I will note that David Richards J and I engaged in collaborative and cordial court-to-court communications in connection with approval of that settlement.

Notwithstanding the election by the administrators in the UK to go it alone, the protocol in practice turned out to be an extremely valuable restructuring tool. The many meetings that took place

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under the authority of the protocol were constructive and yielded a series of bi-lateral agreements that became essential building blocks for Lehman's consensual plan. The plan was confirmed in December 2011 and became effective in March 2012. It is noteworthy that this plan was accepted by an overwhelming percentage of creditors. The many compromises made possible by the protocol were at the source of that very favourable outcome.

Recounting the history of the protocol does lead me to an epiphany of sorts, and despite the success just described, it has some dark overtones for future harmonisation of corporate group insolvencies. Despite the numerous examples of cross-border co-operation in Lehman, I am reminded of the expression attributed to former Speaker of the House of Representatives Tip O'Neill. He famously said: "All politics is local." He was right, of course. And I have come to appreciate that this pithy observation holds true for global insolvency cases as well.

TERRITORIAL CONSIDERATIONS

All insolvencies regardless of their global nature and impact are local. They are driven by territorial considerations and priorities, and that is true even in the most international of cases like Lehman. Each separate proceeding necessarily will treat the interests of local constituencies as a priority, not the collective needs of what once had been a functioning, integrated enterprise group. Ideals of the internationalist will fade if those ideals do not benefit home court creditors.

Judges and former judges, academics and practitioners can all strive for universal procedures, like the Lehman Protocol, that will extend to cross-border insolvency cases, but I am convinced that economic actors seeking to maximise recoveries inevitably will revert to what is in their own self-interest. Such actors will choose to co-operate across borders only when it serves their goals to do so. That leads to a grim recognition. We do business globally but resolve insolvency claims locally.

A judge sitting in New York cannot, as I tried to do, succeed in persuading administrators in the UK to subscribe to a document that was conceived in the US when their duties are prescribed by statute, rooted in a high functioning business culture and territorially circumscribed. Globalisation has natural limits and cannot override embedded local priorities, customs and practices. The insolvency laws and procedures applicable to separate proceedings are not fully congruent, and it is unlikely that they ever will be.

In an ideal world, it would be desirable for the insolvency laws of countries with advanced economies to be more compatible than they are today. We will all benefit from predictable procedures applicable to an insolvent group of companies with cross-border assets and operations and should not have to make up a new protocol each time we confront a corporate group failure that impacts our two jurisdictions or that affects other parts of the world.

CONCLUSIONS

As shown by the Maxwell experience, judges and estate fiduciaries can find ways to work together for the benefit of stakeholders. Mutual self-interest is the key to successful cross-border case management and a strong motivator that can promote more co-operative behaviour. This *ad hoc* approach to working together as exemplified by the Lehman Protocol is consistent with the doctrine of so-called modified universalism as embodied in the EU Regulations and the Model Law on Cross Border Insolvency adopted in the US as Chapter 15 of our Bankruptcy Code.

These statutory frameworks are a major step in the right direction but are incomplete and inadequate for another failure of Lehman's proportions. Insolvent corporate enterprise groups call for solutions that do not currently exist – perhaps more comprehensive and standardised protocols, international conventions and treaties or expansions of the Model Law. We need a more fully developed international legal architecture to address the failure of groups of companies. The default to territorial protections of local creditors is inefficient from a group perspective and a risk to effective resolution.

While progress has been made in the past six years, particularly in the development of co-ordinated single point of entry resolution procedures, better and more reliable co-ordination of the insolvency regimes of all major economies is needed to address the failure of systemically important financial institutions and other corporate groups that span the globe. Such procedures, protocols and treaties are essential to overcome our territorial tendencies that, if unchecked, potentially may block effective rescue and resolution of corporate groups that operate globally. ■

"Such procedures, protocols and treaties are essential to overcome our territorial tendencies that, if unchecked, potentially may block effective rescue and resolution of corporate groups that operate globally"

1 This article is adapted from a speech given by the author at the Insolvency Lawyers Association dinner on 27 November 2014.

Further reading

- Has English law coped with the Lehman collapse? [2013] 3 JIBFL 131
- Same question, different outcome: s 2(a)(iii) of the ISDA Master Agreement under English and US insolvency law [2011] 3 JIBFL 149
- LexisNexis RANDI blog: What's the latest in the administration of Lehmans?

Feature

KEY POINTS

- We regulate financial firms over and above others to protect consumers and manage systemic risks.
- We could do more to protect consumers, but it is systemic risks which are least understood. Previous regulation increased systemic risk.
- We need to replace risk sensitivity with a new concept of risk capacity.
- Capital adequacy requirements should not be driven by potentially faulty estimates of risk, but by the mis-matches between the risks held by institutions and their capacity to absorb those specific risks.

Author Professor Avinash Persaud

Reinventing financial regulation: sanity is not statistical

This article explains why risk-sensitive regulation should be replaced with a new concept of risk capacity – an institution's capacity to absorb a risk. By restricting natural fits between risk and risk capacity, it is suggested that ring-fencing different sectors of the financial system does not make the system safer.

Financial regulation has lost its compass and been led astray. It needs to be re-invented. The title of this article is the subject and title of my new book to be published by Springer later this year. The perspective of the book is neither that of the neo-liberal, instinctively against any type of regulation, nor that of the unreconstructed socialist, suspicious of any form of private enterprise. If we are to finance the better health and education of all of our citizens, we need economic growth. Growth needs risk-takers. Too little risk taking will starve the economy and dangerously feed political radicalisation. Too much, will flash brightly before plunging us into darkness – as we have recently endured. To get to a Goldilocks amount of risk-taking – not too hot or too much, but not too cold or too little either – requires a fresh take on financial regulation. This is not the same as more or less regulation. That is the binary choice offered to us by competing political ideologies, but what we need is a more substantial reinvention.

RISKS OF RISK-SENSTIVITY REGULATION

We regulate the financial sector over and above the way we regulate other industries because finance poses unusual consumer protection problems and it is highly systemic. If the greengrocer consistently sells you too many bad apples you can easily spot them and almost as easily shop elsewhere with little harm done. Most people buy only a few financial products in their life – a mortgage, a life insurance policy, a pension and maybe a car loan. They rarely find out if they are bad until it is too late to do much about it and the consequences are life changing. They could be unlucky, or they may have been persuaded to purchase something quite inappropriate for their circumstances by a sales person incentivised to do so. More can be done to protect consumers from conflicts of interest and other causes of mis-selling of financial products to vulnerable consumers. However, in general this is an area where the issues are well understood. Systemic risk, on the other hand, is much cited but little understood. It is fast becoming a catchall phrase that means so many things that it really doesn't mean anything in particular. While the book examines issues of consumer protection, the use of civil versus criminal law in financial regulation, bankers' pay and off-shore finance, it is the area of systemic risk on which it really focuses.

The systemic character of banking flows from the nature of the credit economy. When a house owner borrows money from one bank to pay his builder for refurbishment, the builder may deposit the cash in another bank. That second bank may use the builder's deposit to lend cash to someone else, who uses that loan to pay someone who makes a cash deposit in a third bank. One bank's borrowers are another's depositors and yet another's borrowers and so on. No other industry is like that. The failure of one bank, causing the receiver to pull its loans, will bring down many others. That is systemic risk in its most basic form.

Because the shareholders of one bank worry only about the loss of their investment in that bank, and not the combined losses of the other shareholders, depositors and borrowers in all the other banks that would be brought down by the failure of the first bank, they underinvest in the safety of that bank from the perspective of the system. One of the guiding lights of financial regulation – its North Star – is to make all banks take greater precautions than they would if left to their own devices. This is more so the larger the bank and the greater are the likely systemic effects. Regulation should seek to internalise the social externality, with bigger banks facing tougher requirements than their smaller competitors.

During the two decades or more prior to the Global Financial Crisis, markets were considered the source of all that is right and good in the world and government was considered the source of much of what was wrong and bad. In this period regulators lost their mojo. They crafted bank regulation in the image of those they were regulating. Their ambition shrank to encouraging the worst banks to look like the best. Worse, they sought to achieve this by effectively requiring all banks to have as expensive credit and risk models as the biggest banks, so that rather than big banks facing tougher requirements, they had a competitive advantage. Systemic risk went unguarded.

Some of the same regulators who run around today wagging their finger and saying that no bank will be too big to fail or jail, had previously helped to make the banks big. They had also been dismissive of

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the concerns of quite a few of us who argued that the new "risk-sensitive" approach to bank regulation, which emerged in the late 1990s, would make things worse. Risk sensitive sounds so right, but it is in fact, very wrong. Under the mantra of greater risk-sensitivity, prudence and transparency, banks were required to put aside capital for loans they thought were risky and less for those they thought were safe and to make this determination using regulatory approved, risk models, driven off publicly available data.

Banks don't generally get into trouble by issuing loans they estimate will be risky, not least because they have put aside more capital for risky loans, secured more collateral and agreed more covenants that protect the bank. They get into trouble by issuing loans to those they thought were safe, and may well have been at the time, but have become risky. Mark Twain put it well over a hundred years ago when he said that it is not the things you think are dangerous that kill you. That is one of the abiding regulation problems to be solved, but the new regulatory approach made it worse.

Because the banks were using similar risk models fed by the same data, they were all concentrated in the same assets that had appeared to offer the best mix of yield, safety and low correlation. Concentrated purchases of these assets, bidding up prices and bidding down quality, turned these previously safe assets into risky ones. When they turned bad, the risk models instructed all the banks to sell them at the same time, turning them from uncorrelated, stable assets into correlated volatile ones. This sent bank risk models into an apoplexy of asset sales that eviscerated liquidity. Signs of this story were already visible during the Asian crisis, the Long-Term Capital Management (LTCM) debacle and the dotcom bust.[1] Risk-sensitive regulation created systemic risk. In the manner in which regulators sought to make individual banks safe, they made the system unsafe.

To work, the risk models required a fictitious view of risk, one in which there was just one thing called risk which could be dialed up and down. Whenever regulation failed and there was a problem, they would effectively dial it down. Not only was this shutting the stable doors after the horses had bolted, but it created, unintentionally, another systemic risk. Any attempt to reduce risk, merely pushes it somewhere else. When it caused a problem in that new place, they would push it to somewhere else. The logical extension of this approach is that they would keep pushing risk to where they could no longer see it. That isn't a safe place for risk to be.

> "Risk managing the system... should not be dependent on estimates of what is safe or risky. Risk-sensitivity should be chucked out of the window and replaced with a new concept of risk capacity"

A NEW CONCEPT OF RISK-CAPACITY

The starting point of any re-invention is to realise that the process of anointing something as safe, makes it risky – for reasons cited above. Safety is not statistical; it is behavioural. Risk managing the system, therefore, should not be dependent on estimates of what is safe or risky. Risk-sensitivity should be chucked out of the window and replaced with a new concept of risk capacity.

An institution has a risk capacity where it has the capacity to absorb a risk. Take liquidity risk, the risk that an asset will realise a far lower price if you are forced to sell it this minute than if you can sell it anytime within the next year or so. A young pension fund that does not need to raise cash to payout a pension for another five years or more has a capacity for liquidity risk. It can own assets for a long period of time, waiting to sell them at the best time. But the same pension fund may not have much capacity to hold concentrated credit risk. Liquidity risks fall with time, but credit risks rise with time. The likelihood that a credit will blow up over the next hour is much lower than the likelihood that it will blow up anytime within the next five years. A bank with a diversified set of borrowers and overnight depositors has a capacity to absorb credit risks, but little capacity to absorb liquidity risks.

The second key tenet of regulation should be an acknowledgement that different parts of the financial sector have different capacities for absorbing different risks and these differences are a critical source of systemic strength. Ring-fencing different sectors of the financial system does not make it safer. It could make it less safe by restricting natural fits between risk and risk capacity. Capital adequacy requirements should be based on the mis-match between an institution's risk capacity and the risks it is taking. This would create an incentive for institutions with one type of risk capacity to buy assets with that risk, and to sell other assets. Risks will no longer be banished from the visible world and lurk in dark corners, but would be drawn to where they are best absorbed. Then, the system would be safer than its individual parts. Systemic risk is not ignored but addressed. Besides consumer protection, that should be the principal object of regulation. ■

1 See Avinash Persaud, BIS Paper No 2, *Sending the herd off the cliff edge: the dangerous interaction of herding investors and market-sensitive risk management practices*, http://www.bis.org/publ/bppdf/bispap02l.pdf.

Further reading

- The critical importance of Basel's new leverage and stable funding ratios [2013] 1 JIBFL 3
- Basel III: a welcome start but much more to be done [2010] 11 JIBFL 650
- LexisNexis Financial Services blog: Stress testing: how relaxed are you on Basel III and CRD IV capital adequacy drives?

Feature

KEY POINTS

- Restrictions on the assignment of receivables can create problems in practice in financing transactions.
- The Government plans to prohibit them in most cases.
- This is the wrong approach. There are better ways to deal with the problem.

Author Richard Calnan

Ban the ban: prohibiting restrictions on the assignment of receivables

This article summarises the key points in the City of London Law Society's response to the Department for Business, Innovation and Skills' consultation paper, *Nullification of Ban on Invoice Assignment Clauses.*

Receivables are an important element in the wealth of businesses and, for that reason, they are frequently financed. Receivables can be used as security for a loan, or they can be sold under a factoring or securitisation arrangement. Either way, the financing will involve an assignment (statutory or equitable) or a charge over the receivables. This is relatively straightforward.

But most receivables are created by contract, and contracts frequently contain restrictions on assignment. Take, for instance, a simple contract under which a payer has an obligation to pay money to the payee as consideration for goods or services supplied by the payee from time to time. If the contract prohibits the assignment of the receivables without the consent of the payer, then no valid assignment can be created unless the payer consents. Whether or not the particular clause in the contract does prohibit the proposed transaction is a matter of the interpretation of the contract as a whole, read in the context of the background facts at the time the contract was entered into. But if, on its proper interpretation, the intended transaction is prohibited by the contract, then it is ineffective.

This can be an important issue in financings in practice. It is not often a problem in relation to large contracts which it is known have to be financed – because they tend to be drafted with an eye on the need for financing. But, where the financing is over a number of smaller contracts, the financier needs to check the terms of the contracts in order to decide whether they prohibit what is intended; and, if they do, it needs to obtain the consent of the payer – which may, or may not, be forthcoming.

It is for this reason that, when the Financial Law Committee of the City of London Law Society (CLLS) produced a discussion paper on secured transactions reform in November 2012,[1] the paper contained a section on restrictions on assignment. A working party of the CLLS is continuing to consider the issues concerned. In particular, it is considering how contracts should best be drafted in order to protect the legitimate interests of the payer, whilst at the same time enabling the payee to finance the receivable.

And then the Government entered the debate. In 2014, it published a Small Business, Enterprise and Employment Bill which would, in most cases, have overridden prohibitions on assignment. Then, in December 2014, the Department for Business, Innovation and Skills (DBIS) published the consultation paper *Nullification of Ban on Invoice Assignment Clauses*. At the same time, it published a draft statutory instrument – The Business Contract Terms (Restrictions on Assignment of Receivables) Regulations 2015. The effect of these regulations would be to override a term of a contract to the extent that it prohibits or restricts the assignment of receivables. It would apply to all contracts unless specifically excluded.

In February 2015, the CLLS responded to the consultation paper.[2] It made two key comments. First, it considered that the proposed legislation approaches the issue in the wrong way, and that there are preferable ways to deal with it. It is not an answer to the problem caused by restrictions on assignment simply to invalidate them. Secondly, it argued that, if the legislation is to proceed, it needs to protect the payer properly and more thought needs to be given to the extent of its application.

This article summarises the key points in the CLLS response.

FREEDOM OF CONTRACT

It is axiomatic that the parties to a commercial contract can decide its terms, and therefore whether or not it can be assigned. No-one has expressed the importance of freedom of contract better than Sir George Jessel MR in *Printing and Numerical Registering Company v Sampson* (1874-75) LR 19 Eq 462 at 465:

> "It must not be forgotten that you are not to extend arbitrarily those rules which say that a given contract is void as being against public policy, because if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by courts of justice. Therefore, you have this paramount public policy to consider – that you are not lightly to interfere with this freedom of contract."

Of course, that statement was made during the glory days of Victorian free trade. Freedom of contract suffered a setback in the 20th century, largely because of concerns about consumer protection. But, since *Photo Production v Securicor* [1980] AC 827 in the 1980s, the pendulum has swung back in commercial cases in favour of freedom of contract. Now that consumers are catered for by legislation, there is no reason why freedom of contract should not prevail in the commercial sphere.

Parties from all over the world choose English law to govern their contracts. They do this because English law gives effect to what the parties have agreed. Apart from the penalty doctrine – which is now an historical anomaly – a court can very rarely override what the parties have agreed.

Freedom of contract should only be restricted in commercial transactions in

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exceptional circumstances – where there is clear evidence that allowing the parties to decide for themselves materially damages the UK economy. We have not seen such evidence in relation to restrictions on assignment. And if there is a problem in particular sectors, this is best dealt with by competition and regulatory law in a manner proportionate to the risks involved, not by a blanket ban.

There is no doubt that restrictions on assignment can cause practical problems in financing transactions. That is why a working party of the CLLS is looking at them at the moment. But the problem is not so grave that it warrants overriding the rights of one party to a contract in order to give an advantage to the other party.

The draft regulations exclude from their scope certain types of contract (such as contracts for financial services) where it is considered that the parties should be free to restrict assignment. It is recognised – quite rightly – that a payer may have a perfectly good reason why it wants to restrict the assignability of a receivable in a financial services contract. But this is also true of other types of contract. It is impossible to specify all those types of contract where the payer may have a legitimate commercial reason for restricting the identity of its payee. In a commercial context, this should be left to the parties to decide.

It is for this reason that the best way to deal with the problem is consensually – by explaining the issues to the parties and encouraging them to agree restrictions on transfer which allow receivables to be sold or charged by the payee whilst at the same time protecting the legitimate interests of the payer. The right approach is very much dependent on the particular contract concerned. The issues are too nuanced to be solved by legislation which simply prohibits certain contractual provisions.

There is no doubt that, in many contracts, restrictions on assignment are inserted with very little thought being given to their purpose and effect. But there are other cases where these provisions are carefully drafted to serve a particular purpose, or are negotiated between the parties in order to reflect the agreement they have reached. What is needed in practice is a better understanding of the types of restriction, and their effects. This process can be assisted by the drafting of model clauses and commentaries. But what is totally unhelpful is legislation which rides roughshod over the parties' agreement.

PROTECTING THE PAYER

The payer should not suffer as a result of its contract being overridden. If legislation is to be passed, it should make it clear that the payer's economic obligations will not be increased as a result of the payee assigning receivables to a third party in breach of the terms of the contract.

For instance, the payer should be able to exercise the same rights of set-off which it would have had in the absence of the assignment. This would not be the case under the general law. Once notice of assignment is given, the payer is unable to exercise new rights of set-off which it obtains against the assignor. The payer ought to be able to exercise these rights against the assignee, even though there has been an assignment. If the contract prevents assignment, it would be unfair on the payer to require it to pay more than it would have had to pay if the terms of the contract had been complied with.

THE SCOPE OF THE LEGISLATION

The draft regulations override restrictions on assignment in any contract to which they apply. There are three elements of uncertainty here.

The first is the type of transaction which the legislation is intended to override. It is expressed to apply to assignments of receivables. This is presumably intended to cover security assignments as well as to outright assignments, but there is no reference to charges. Are they intended to be covered, or not?

The second concern relates to the identity of the companies which can benefit from the regulations. It appears from the consultation paper that the key driver for the legislation is the protection of small businesses. But there is nothing in the draft legislation which restricts its application to small businesses. The regulations outlaw restrictions on assignment in any relevant contract, even if it is made between two large multi-national companies. Is that really the intention?

Indeed, even if it were restricted to small companies, it should not be forgotten that, for every small company which is owed a receivable, there is another small company which owes one. Is it appropriate to override the interests of a small company payer in favour of a large company payee?

The final concern involves the territorial scope of the legislation. There is no indication in the regulations as to the extent of its territorial application. Is it intended to apply to all contracts governed by English law, regardless of where the parties are situated? Or is it meant to apply to contracts between parties situated in the UK, regardless of the law which governs them? Or is there to be some combination of these two tests? These are crucial questions, and there is nothing in the draft regulations which deals with them. There is potential here for significant damage to the use of English law by parties to international contracts.

CONCLUSION

There is no doubt that restrictions on assignment can cause problems in practice. But that is not a reason to cut across the basic principle of freedom of contract in commercial transactions. What is needed is an approach which understands the legitimate reasons why parties impose restrictions and which helps the parties to agree provisions which recognise that they both have an interest in achieving a sensible outcome. ■

1 *CLLS Financial Law Committee Discussion Paper on Secured Transaction Reform*, 22 November 2012. See www.citysolicitors.org.uk; select "City of London Law Society", then "Committees" and then "Financial Law".

2 *CLLS Response to DBIS on Nullification on Ban on Invoice Assignment Clauses*, 2 February 2015. See www.citysolicitors.org.uk as above.

Further reading

- Prohibitions on assignment: Contract or property? [2014] 11 JIBFL 692
- Fixed and floating charges: the Great British Fund-Off? [2015] 1 JIBFL 3
- LexisNexis Loan Ranger blog: Real impetus for reform and research into English law on secured transactions

KEY POINTS

- *Bass Jarrington v RBS* was a case for summary judgment against a bank where a guarantee had been given without board authorisation and without apparent consideration of corporate benefit.
- Statutory and common law rules are analysed to understand the basis upon which a lender might not be able to rely on a guarantee given to it by a borrower – those rules appear to be converging towards a requirement that a lender must not be "dishonest or irrational (which includes turning a blind eye and being reckless)".
- Some "golden rules" for lenders are suggested.

Author Jonathan Porteous

Not feeling the (corporate) benefit? A chill wind for lenders?

This article suggests some "golden rules" for lenders taking upstream or cross-stream corporate guarantees, following recent case law.

The recent case of *Bass Jarrington v RBS*[1] again raised the spectre of guarantees failing on grounds of lack of corporate benefit. In *Bass Jarrington*, a company gave a guarantee to RBS of the obligations of a sister group company. A certificate of a board resolution was provided to RBS in its standard form, but the meeting never took place. Despite being urged to do so by the bank, there is no evidence that the directors ever considered what corporate benefit would accrue to the company from giving the guarantee.

The company made an application for summary judgment against the bank, a claim for which Master Bowles clearly had little sympathy, directing, perhaps unsurprisingly, that the issues raised would have to go to trial.

"Will a lender be exposed every time it takes the benefit of a corporate guarantee without sufficient evidence of corporate benefit accruing to the guarantor and/or the directors having sufficiently considered the point?"

But the case does raise a rather alarming prospect for lenders. Will a lender be exposed every time it takes the benefit of a corporate guarantee without sufficient evidence of corporate benefit accruing to the guarantor and/or the directors having sufficiently considered the point?

This article analyses the law in this difficult and crucial area, with a view to the scenario where a lender wishes to take an upstream or cross-stream guarantee from a borrower's subsidiary or sister company. On what grounds might such a guarantee be challenged on grounds of lack of corporate benefit and/or lack of authority, whether actual or apparent?[2]

WHAT IF THE TRANSACTION IS OUTSIDE THE LIMITATIONS IN THE COMPANY'S CONSTITUTION?

Historically, it was very important to examine the objects clause of the company in its memorandum of association to determine whether or not an action was *ultra vires* the company. A counterparty was also on notice of restrictions in the company's articles of association and could not enforce a transaction in breach of them.

Now, under s 39(1) of the Companies Act 2006, "the validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution".[3]

Additionally, under s 40(1) of the Act: "in favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorise others to do so, is deemed to be free of any limitation under the company's constitution".

Further, s 44(5) of the Act provides that a document executed by two authorised signatories or by a director in the presence of a witness who attests the signature is deemed to have been duly executed by the company, in favour of a purchaser (which includes a mortgagee) in good faith and for valuable consideration.

Previously, a counterparty could suffer even if acting in good faith, most famously perhaps in *Hazell v Hammersmith & Fulham LBC*,[4] which decided that swap transactions were *ultra vires* the council and therefore not binding on it. Now, a counterparty will be able to rely on the power of the directors to bind the company if a counterparty is acting in good faith, and the fact that the transaction was in breach of the company's constitution will not of itself invalidate it.[5]

WHAT IF A COUNTERPARTY KNOWS, OR SHOULD HAVE KNOWN, THAT THE TRANSACTION WAS IN BREACH OF THE COMPANY'S CONSTITUTION?

At one time, a party could not rely on a transaction if it should have known that the transaction was not authorised by the company's constitution. Now s 40(2)(b)(i) of the Act provides that "a person dealing with a company is not bound to enquire as to any limitation on the powers of the directors to bind the company or authorise others to do so". Such a person "is not to be regarded as acting in bad faith by reason only of his knowing that an act is beyond the powers of the directors under the company's constitution".

But as we will see, this does not mean

that it is irrelevant that a counterparty knows that a transaction is beyond the directors' powers. It may be relevant to the determination of whether that party is acting in good faith under ss 40 and 44, and to cases where ss 40 and 44 do not apply but a director arguably has apparent authority to bind the company (see below).

WHAT IF THE TRANSACTION DID NOT HAVE FULL BOARD APPROVAL?

A lender would normally want to obtain evidence of a board resolution authorising a financing. However, this is not always the case. Sometimes a "board minute" is signed when the meeting never actually happened. In *Bass Jarrington*, the claimant contended that a certificate sent to the bank evidencing a board resolution was a fiction, and that no board meeting was ever held. Although the point was not relevant to his decision, Master Bowles concluded that s 40 of the Companies Act 2006 would not apply where the transaction in question was not founded upon an actual board resolution. This suggests that a bank taking a guarantee from a company should always request a board resolution as evidence that the transaction has been authorised by the board.

It is worth noting that this is at odds with the view of Buckley[6] who (along with other commentators) regards it as significant that s 40 refers to limitations on "the power of directors" (rather than reference to "the power of the board of directors" in the equivalent (now repealed) provision in the Companies Act 1985). Buckley sees this change as a clarification that the provision applies to both acts of the board and of individual directors. Even so, the counterparty should inquire whether the person acting for the company has in fact been authorised (by requesting a copy of the board resolution or power of attorney conferring such authority). This is especially important where the counterparty knows or suspects breach of duty, as this could undermine the requirement for the counterparty to be acting in good faith, and therefore remove the protection of ss 40 and 44.

There is also uncertainty whether s 40 will assist a counterparty if a board meeting does not satisfy quorum requirements. In a Court of Appeal case it was held by majority that the predecessor to s 40 (s 35A of the Companies Act 1985) did apply in such a case[7] and Buckley [at 1963] is of the view that a lack of quorum would clearly come within the protection of s 40.

If s 40 did not apply the lender may still be able to rely on apparent authority of the director(s) – see below.

Section 44(5) should apply where a document is purported to be executed by the company. Section 44(5) protects a purchaser in good faith for valuable consideration so long as the document purports to be signed by two authorised signatories (ie by two directors or a director and secretary), or by a director and attested by a witness. In *Lovett v Carson Country Homes Ltd*,[8] a director forged his co-director's signature on a guarantee and debenture but the court concluded that the company was still bound by it. In *Lovett* it was held that forbearing to enforce a loan was valuable consideration for the taking of the guarantee and the debenture.

> "It is not clear that s 40 applies to protect a counterparty where the directors... are not acting in the best interests of the company, or are in breach of some other fiduciary duty"

The good faith requirement is discussed below.

WHAT IF THERE IS NO CORPORATE BENEFIT IN GIVING THE GUARANTEE, AND THE DIRECTORS AUTHORISING IT ARE IN BREACH OF DUTY?

It is not clear that s 40 applies to protect a counterparty where the directors, though not acting in breach of any express restriction in the constitution, are not acting in the best interests of the company, or are in breach of some other fiduciary duty.[9] (See box below, Is a guarantee in the

IS A GUARANTEE IN THE BEST INTERESTS OF A COMPANY?

Factors to consider include the following:

- Is the company solvent? If so, obtain a shareholders' resolution to support the decision unless not market practice, impossible or impracticable.
- Is the company obtaining the benefit of the facilities being guaranteed, either directly from the lender or indirectly from its parent company or another group company?
- Are the directors satisfied that the guaranteed party or parties have the ability to service and repay the guaranteed debt based on information available at the time of entry into the guarantee?
- Would there be adverse consequences for the company if it refused to guarantee the debt (and the lender refused to make the debt available)? If so, then the directors may conclude that on balance giving the guarantee is in the company's best interests.
- Can the company afford to meet the guaranteed obligations in full? For a subsidiary, this will often not be the case but the subsidiary will need to be satisfied that the principal debtor and any other guarantors have those resources.
- If the benefits are insufficient to outweigh the disadvantages, consider limits on liability, limited recourse, guarantee fees, other concessions or inducements to be offered to the guaranteeing entity – particularly applicable in cross-stream guarantees.

best interests of a company?) There are few if any cases where s 40 (or its predecessor s 35A of the 1985 Act) have been applied to an instance where directors were acting in breach of fiduciary duty.[10]

However, s 44(5) may still apply it seems, to protect a purchaser in good faith, even if the document was not authorised by the board and the director signing was in breach of duty.[11]

If ss 40 and 44 do not apply, then whether a counterparty can enforce the contract is decided on agency principles, as discussed below, and in particular, based on an assessment as to whether the director or directors in question had apparent authority to bind the company to the transaction in question.

> "In fact, whether ss 40 and 44 apply or not, it is likely that the outcome would be similar whether the matter is considered under the statutory or the common law rules"

In fact, whether ss 40 and 44 apply or not, it is likely that the outcome would be similar whether the matter is considered under the statutory or the common law rules. The question of enforceability of the contract by the counterparty under ss 40 and 44 would turn on an assessment of whether that counterparty was acting in good faith, and on common law agency principles it would be a question of whether that counterparty could rely on the representation of authority of the agent in order to find there was apparent authority. As discussed below, that assessment is not dissimilar from a good faith assessment on the part of the counterparty.

In *LNOC Ltd v Watford Association Football Club Ltd*,[12] Judge Mackie was of the view that the test for negating apparent authority as set out in *Akai* (see below) should be equated with the statutory good faith test – see "The new test" below.

As Buckley points out [at para 1958] one difference between the common law and statutory provisions is that at common law it is for the person dealing with the agent to establish the authority of the agent while under ss 40 and 44 it is for the company to prove the lack of good faith of the counterparty.

APPLICATION OF COMMON LAW AGENCY PRINCIPLES

Directors acting in breach of fiduciary duty will never have *actual* authority to bind the company – by definition, they are acting beyond their powers. If the counterparty knows that the agent is exceeding his powers then that act is not binding on the principal.[13]

But a principal may still be bound by the acts of his agent if his agent had *apparent* or *ostensible* authority to bind the company. A counterparty can only rely on apparent authority if he is not aware the agent had no actual authority. Therefore if a counterparty knows that the agent is acting in breach of his fiduciary duties then he cannot enforce the contract.[14]

Requirements for finding apparent authority

Starting point

The leading case is *Freeman & Leisure v Buckhurst Park Properties (Mangal) Ltd*.[15] In that case, Lord Diplock set out four requirements for finding apparent authority (or ostensible authority as he called it):

- A representation must be made to the counterparty that the agent had authority to enter into a contract of the kind sought to be enforced.
- Such representation must be made by persons who had actual authority to manage the business of the company.
- The counterparty relied on that representation.
- The company had capacity under its memorandum and articles to enter such a transaction.

Development of the rule

Where a lender is taking a guarantee, it will normally expect to see a board resolution supporting the decision, which will normally satisfy the first two tests in *Freeman & Leisure*. But the courts have provided a gloss to the third test, to the effect that a counterparty must be justified in relying on the representation. The courts developed a concept of the counterparty being put on notice by abnormal circumstances. For example, in *Rolled Steel*,[16] it was held that a counterparty with actual *or constructive* notice of directors acting in breach of their duties could not rely on the transaction. In *Bass Jarrington*, it was argued that where a company purported to enter into a transaction such as a guarantee which it was not in its ordinary course of business to provide, the recipient is put on enquiry as to the authority of the directors to give that guarantee, and failure to make that enquiry and be satisfied by it will mean that the counterparty may not rely on that guarantee if it turns out the directors were exceeding their powers in granting it.

The new test

But Master Bowles in *Bass Jarrington* preferred to follow the analysis of Lord Neuberger in *Akai Holdings (in liquidation) v Kasikorn bank*, a case from the Hong Kong Court of Final Appeal.[17] In that case Lord Neuberger considered in detail the requisite state of mind of the counterparty alleging apparent authority. He observed that, because apparent authority is a species of estoppel by representation, the doctrine of constructive notice is not relevant. After a review of the case law, he concluded that the bank was entitled to rely on the managing director's apparent authority unless that belief was "*dishonest or irrational (which includes turning a blind eye and being reckless)*".

This *dictum* has since been followed in a number of British cases[18] and it now appears to be the correct test for negating a finding of apparent authority, and possibly (and as

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suggested by Mackie J in *LNOC v Watford Football Club*), also the appropriate test for establishing good faith for the purposes of ss 40 and 44 of the Companies Act 2006.

A notable application of the new rule (and how it differs from the constructive notice/put on enquiry test) was demonstrated in the Court of Appeal case *Quinn v CC Automotive Group Ltd*.[19] In that case, a man was anxious to buy a new red Jaguar in time for his daughter's wedding. He traded in his silver Jaguar for the new one with the assistance of an apparently helpful employee of a car dealership, who carried out the transactions from a motorway service station and promised to sort out the car finance on the customer's existing car. In the event he was a rogue, the red Jaguar was not his to sell and the customer was pursued for the original finance. At first instance the customer lost because he should have been put on enquiry by some of the unusual features of the transaction. But the Court of Appeal, applying Lord Neuberger's *dictum*, was clear that the customer had no duty to enquire – it was only relevant whether the customer "turned a blind eye" to the irregularities (which he had not).

PRACTICAL GUIDANCE FOR LENDERS

So assuming the *Akai* formulation is now the test for both good faith under ss 40 and 44, and for findings of apparent authority, should lenders breathe a sigh of relief that the bar seems to be that much higher, and the rather insidious "a guarantee puts a lender on enquiry" test seems to be out of favour?

Lenders should not get too comfortable. In *Akai* the bank lost – it had sanctioned a loan to Akai which was used to repay a debt owing to the bank by a struggling borrower under common ownership with the majority owner of Akai, although both parties had minority interests owned by the public. The transaction was clearly of dubious benefit to Akai and was of very great benefit to the bank. There was a strong sense that the bank was prepared to overlook all the abnormalities of the deal out of self-interest. Additionally the transaction was not properly sanctioned by the board of the borrower although it is not clear this would have saved the bank in the circumstances.

Taking into account a review of the relevant cases, the golden rules for lenders taking upstream or cross-stream corporate guarantees are as follows:

- Consider whether there is any doubt as to whether the transaction is in the best interests of the company – see box, p 139.

> "... should lenders breathe a sigh of relief that the bar seems to be that much higher, and the rather insidious 'a guarantee puts a lender on enquiry' test seems to be out of favour?"

- If there is: (i) require a shareholders' resolution approving the entry into the guarantee (assuming the borrower is solvent); and (ii) ask the directors to provide a draft board minute setting out in detail the reasons why there is corporate benefit – note this should be drafted by the borrower and its lawyers, not offered by the lender.
- Ensure the lender can be said to be acting in good faith and not turning a blind eye or being reckless to the directors not acting in the best interest of the company.
- Obtain a board resolution from a quorate board meeting.
- Obtain documents duly executed by the company. ■

1 Chancery Case judgment, 7/11/14, No HC13C02505.
2 In the analysis below we are focusing purely on corporate benefit and on lack of authority – as readers will know there are various other rules and presumptions of law which may operate to discharge a guarantee – see, for example, *Holme v Brunskill* (1878) 3 QBD 495 where amendments to the principal obligation made without the guarantor's consent operated to discharge the guarantee.
3 Ie principally its articles of association.
4 1992 2 AC 1.
5 Although there is an exception for charitable companies.
6 See Buckley at [1961] and [1963].
7 *Smith v Henniker-Major* 2002 BCC 544.
8 [2009] EHWC 1143 Ch.
9 See Gore Browne (at 8-15) and discussed in *Bass Jarrington* at para 115.
10 For example, the cases of *Criterion Properties PLLC v Stratford UK Properties LLC* [2004] 1 WLR 1846 and *Wrexham Association Football Club v Crucialmove Ltd* [2006] EWCA Civ 137, cited in Tolley's at U3019 in a discussion of good faith under this section, actually doubted whether board approval had been obtained in each case and placed more weight on agency principles.
11 See, for example, *Lovett v Carson Country Homes Ltd* [2009] EHWC 1143 Ch and *LNOC v Watford Football Club* [2013] EWHC 3615.
12 [2013] EWHC 3615.
13 See *Bass Jarrington* at para 24 and Bowstead & Reynolds on Agency, 19th ed at para 8-049.
14 See, for example, *Capitol Films* [2010] EWHC 2240 (ch) and *Criterion Properties PLLC v Stratford UK Properties LLC* [2004] 1 WLR 1846.
15 1964 2 QB 480 CA.
16 *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* (BCLC 1984 99158).
17 2010 HKCFA 63.
18 For example, *Gaydamak v Leviev* [2012] EWHC 1740 and *Newcastle International Airport v Eversheds* [2013] PNLR 5 and *LNOC v Watford Football Club* [2013] EWHC 3615.
19 [2010] EWCA Civ 1412.

Further reading

- Releases of guarantees and security [2009] 5 JIBFL 245
- Beyond change of control [2006] 11 JIBFL 475
- Lexis PSL: Banking & Finance: Guarantees – corporate benefit

Feature

KEY POINTS

- Compensatory damages are limited as a matter of policy, as recovery of all financial loss would be far too onerous.
- As legal principles apply to claims commenced both in and outside court, expectations as to recoverable losses for mis-selling need to be reconciled with the law governing recoverability.
- Claims for loss of profit remain fact-sensitive, and commonly face significant hurdles in causation and remoteness.
- Investors often mistakenly claim virtually all financial losses as consequential loss, notwithstanding authority limiting such loss to Limb II of *Hadley v Baxendale*.
- Greater understanding on how to formulate claims correctly, particularly for consequential loss, is essential to ensure reasonable levels of compensation and satisfaction for claimants and defendants alike.

Authors Ebony Alleyne and Joel Seager

Opportunity doesn't knock twice: recovering damages for consequential loss

Today's banks are in receipt of the largest fines ever imposed by the Financial Conduct Authority (FCA), or its predecessor the Financial Services Authority (FSA), and although they are taking responsibility for a number of failings (eg PPI, Derivatives, LIBOR and FOREX), restrictions on recovering loss, in particular where consequential loss is concerned, have come under significant scrutiny. This article examines the measure of loss in tort and contract, and particularly explores investors' difficulties when making claims for loss of profit caused by mis-selling.

MIS-SOLD FINANCIAL PRODUCTS

Many view mis-selling as a particularly apt scenario in which a bank should pay full compensation; particularly if, absent the mis-selling in question, the investor would not have purchased a financial product at all.

However, few investors are able, or indeed entitled, to recover all their perceived losses. The first problem with the idea of being entitled to "full compensation" is that English law does not apply an indemnity principle to the assessment of damages. The second is the question of how best to apply the term "consequential losses" in the context of mis-selling, to enable investors to better understand, identify, quantify and present all their losses in practice.

This is all in stark contrast to the straightforward calculation of net payments made by the investor for a mis-sold product (the most obvious direct loss); and frequently creates a gulf between expectations and outcome in relation to recovering other losses.

To make sense of why investors are unlikely to recover full compensation and the limits on recoverability of consequential losses it is necessary to consider the available causes of action before the courts and the approach to assessment of damages in English law.

LEGAL PRINCIPLES

Mis-selling claims based on inappropriate advice are commonly brought in:

- *tort*; and/or
- *contract*; with claims for
- *breach of statutory duty* and *misrepresentation* also regularly made (ie breaches of the FSA's Conduct of Business Rules or the FCA's replacement Conduct of Business Sourcebook Rules, and statutory misrepresentation under the Misrepresentation Act 1967).

The starting point for considering compensation in tort is the intention to restore the investor to the position he would have occupied absent the tort (as per *Livingstone v Rawyards Coal*). In contract, it is slightly different; the intention being to place the investor in the position he would have been in if the contract had been performed (as per *Robinson v Harman*).

English law supplements these starting points with several exclusionary rules. The policy reasons are clear and, as far back as *Victoria Laundry v Newman Industries*, Asquith LJ said (of the starting point in contract):

> "This purpose, if relentlessly pursued, would provide [the claimant] with a complete indemnity for all loss *de facto* resulting from a particular breach, however improbable, however unpredictable. This, in contract at least, is recognised as too harsh a rule. Hence, in cases of breach of contract the aggrieved party is only entitled to recover such part of the loss actually resulting as was at the time of the contract reasonably foreseeable as liable to result from the breach. What was at that time reasonably so foreseeable depends on the knowledge then possessed by the parties or, at all events, by the party who later commits the breach."

REMOTENESS

It is axiomatic that, in tort, investors need to establish that they were owed a duty which was breached; that the breach caused the consequential loss complained of; and that the type of losses claimed are not too remote (ie each type of loss was one a reasonable person might anticipate). If the losses are not too remote, the likelihood/certainty of each loss, and its value, must still be established if the investor is to recover.

Tortious losses are not too remote if they fall within an objectively predictable range, regardless of whether they were sustained in an unforeseeable way. In contract, the test of remoteness is more restrictive, inasmuch as, where the type of loss was reasonably foreseeable by the defendant at the time of the contract, as being "not unlikely" to result from his breach, then that loss is not too remote (as per *The Heron II*) – unless parties in their particular sector would not reasonably be considered to have intended to assume such liability (as per *The Achilleas*).

The conventional approach to the question of remoteness (in contract) dates back to the judgment of Alderson B in *Hadley v Baxendale*, in which losses were split into two limbs:

- *Limb I*: direct losses, where the type of loss was reasonably foreseeable as not unlikely to result from the breach concerned, in the ordinary course of things; and
- *Limb II*: indirect loss, where the type of loss arises from the special circumstances of the case that could reasonably be supposed to have been in the parties' contemplation when the contract was made.

The case of *Victoria Laundry* considers the distinction between the two limbs. The defendant was an engineering company supplying a boiler to a laundry. As the date for delivery of the boiler was exceeded by some five months, the laundry lost lucrative contracts. The court concluded the engineering company knew, or ought to have known, the nature of the laundry's business with the effect that Limb I/direct losses could reasonably be expected over the period of the delay, including loss of profit equivalent to the value of general laundry and dyeing contracts. However, as the engineering company had not known of the laundry's opportunity to enter into even more lucrative dyeing contracts, for the Ministry of Supply, the significant loss of profit from those potential contracts was deemed too remote.

The principles in relation to remoteness in tort are more generous; and investors may have longer to bring claims in tort than in contract (by virtue of a later date of knowledge under s 14 of the Limitation Act 1980). They may also avoid potential pitfalls presented by contractual exclusion clauses and defences such as contractual estoppel.

Fortunately for investors, contractual principles are not always strictly applied. Where interest rate hedging products were sold to un-sophisticated customers from December 2001, for example, the banks agreed (with the FCA) to review all sales and, where appropriate, to pay customers fair and reasonable redress; and to the credit of the FCA and the banks, the nuances between causes of action have largely been glossed over by the approach taken in the review (which limits the applicable legal principles to those governing claims in tort and for breach of statutory duty).

In cases of mis-selling, most investors assert that absent the breach they would not have taken a financial product at all. Unsurprisingly, such investors often blame the banks for all perceived consequential loss, whereby their own analysis suggests: "If the bank hadn't sold me X financial product, I would have used the money for Y, and received a greater profit of Z."

As for the heads of loss claimed (namely Z in the above analysis), the often contentious types of consequential loss claimed tend to be:

(i) *loss of profit* (usually advanced when a specific contract or project was lost or typical contracts or projects could not be pursued) – here, damages can usually be calculated by reference to past profits achieved on such contracts/projects;
(ii) *loss of a chance* (usually advanced where profit-making rested solely on the decision or act of a third party; however the investor lost the chance to tender or compete at all) – here, damage is assessed in percentage terms, by reference to the chances of success.

It is common for the amount said to make up the opportunity cost incurred as a result of making payments under the product (namely the alternative profit-making opportunity lost), to be the most valuable head of consequential loss. It is also common for investors to rely upon complex hypothetical scenarios setting out what would have happened and it is well established, that hypothetical scenarios may lead to recovery of loss of profit (such as in *East v Maurer*).

For example, where an investor is known to the bank to purchase residential

> "… investors often blame the banks for all perceived consequential loss, whereby their own analysis suggests: If the bank hadn't sold me X financial product, I would have used the money for Y, and received a greater profit of Z"

WHAT WOULD HAVE HAPPENED?

Where mis-selling is admitted, it has been suggested (by analogy with a case concerning negligent advice given by a firm of solicitors – *Levicom International v Linklaters*) that the evidential burden may in fact shift to the bank to show that the mis-selling was not the cause of the losses claimed, although that is far from a settled or accepted view. Hence, the burden of proof still rests on a claimant to prove causation, both in and out of court.

properties for rental purposes, and the investor claims money he paid under a mis-sold financial product would have instead been used to grow his profit-making property portfolio; if the investor can identify property available to him at the relevant time, he is likely to recover any capital appreciation and the value of net rental income as loss of profit (in contract or tort). Whereas an investor who can only say he would have looked for investment properties if he had retained his money instead of purchasing the mis-sold product, has the additional causation hurdles, of showing he would indeed have sought and found and been able to purchase, such property.

In *Parabola Investments v Browallia* Toulson LJ stated:

> "Some claims for consequential loss are capable of being established with precision (for example, expenses incurred prior to the date of trial). Other forms of consequential loss are not capable of similarly precise calculation because they involve the attempted measurement of things which would or might have happened (or might not have happened) but for the defendant's wrongful conduct, as distinct from things which have happened. In such a situation the law does not require a claimant to perform the impossible, nor does it apply the balance of probability test to the measurement of the loss."

This suggests that if the second investor can show (on the balance of probabilities) that he could and would have bought property, the fact that a precise purchase is not identified would not be fatal. Furthermore, the court would not apply the balance of probability test when measuring loss, as noted in *Parabola*.

Having said that, one might also accept that in volatile markets (capable of rapid and extreme price movements), recovery for adverse market movement is likely to be too speculative a claim; however there has been some softening of judicial opinion in that regard. Tomlinson LJ cast doubt on his previous decision in *Pindell v Air Asia* that losses caused by extremely volatile market conditions were, by their very nature, irrecoverable. In the case of *John Grimes Partnership v Gubbins*, he noted he had been incautious when previously suggesting the same, and permitted a land developer (Grimes) to recover losses incurred due to a 14% fall in the property market.

Given the importance of knowledge of special circumstances when considering whether a loss is too remote, one potential advantage an investor may have, is the level of access a bank usually has to details of the investor's financial circumstances and plans at the time financial products are purchased. Records created during due diligence checks are likely to be retained by banks for regulatory purposes, and may well assist investors seeking to demonstrate that the bank had knowledge of the purpose for which the investor sought to enter into the financial contract, and/or had knowledge of the use to which the investor intended to put any additional funds or profit.

INTERPRETATION OF "CONSEQUENTIAL LOSS"

There remain a significant number of expressions in everyday commercial use that have no accurate corresponding legal definition; "consequential loss" being one of them.

Whilst the prevailing commercial approach largely treats consequential loss as a synonym for indirect loss; direct losses can still be extensive, and direct loss often includes loss of profit in many commercial contracts.

Needless to say, many contracting parties seek to restrict liability by way of (unfortunately) ambiguous exclusion clauses that preclude liability for "any indirect or consequential loss howsoever caused". Such wording assumes consequential loss includes all loss of profit; and has a perceived attraction that, being non-specific, it might expand the types of loss capable of exclusion. Of course, this overlooks the fact that, as far back as *Victoria Laundry*, a portion of lost profit was already considered direct loss.

In *Croudace Construction v Cawoods*, the Court of Appeal confirmed that consequential loss should be confined to loss or damage within Limb II of *Hadley v Baxendale*. This resulted in a line of authorities in which a similar narrow interpretation of consequential loss has prevailed (including *British Sugar v NEI Power Projects*; *Deepak Fertilisers v ICI*; *Hotel Services v Hilton*; and *McCain Foods v Eco-Tec*). The effect has been to restrict the application of exclusion clauses that purported to speak to "consequential loss".

Where cases involved the sale of profit-generating assets or projects (as in *Deepak Fertilisers v ICI* and *Hotel Services v Hilton*), the courts demonstrated willingness to construe loss of profit as a direct loss within Limb I of *Hadley v Baxendale*. Hence, such loss would be recoverable notwithstanding an exclusion clause precluding recovery of consequential loss. As a result, where the purpose of a contract is to provide a product intended to generate profit, the court is likely to construe the lost profit the product would have made, as a direct loss.

Admittedly, contracts for financial products, such as swaps, caps and collars used by investors to limit exposure to interest rate fluctuations, may rarely provide a factual basis for construing loss of profit as a direct loss, nevertheless it is important to realise that a particular set of facts may still involve an overlap, where some losses considered indirect/consequential, are (in law) recoverable as direct losses.

Over time, the restrictive construction of "consequential loss" has been subject to increased scrutiny. The leading text, *McGregor on Damages*, suggests a split between normal and consequential losses; describing normal losses as the type every claimant in a like situation will suffer, and consequential losses as those born of the claimant's particular circumstances. However, as both types of loss are only recoverable if the loss is not too remote, it is questionable whether there is any particular bite to the distinction being made. Notably,

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McGregor goes on to state that limiting consequential loss in contract to Limb II of *Hadley v Baxendale* is illogical, and that the line of Court of Appeal authorities in that regard, require attention from the Supreme Court. In contrast, in *Caledonia North Sea v BT*, Lord Hoffmann only queried whether the reasoning in cases such as *Hotel Services v Hilton* was correct.

The classification of loss of profit is therefore extremely fact-sensitive; and the attractive simplicity of assuming consequential loss covers all losses beyond net payments made under a mis-sold financial product, and of treating "consequential loss" as a simple substitute for "indirect loss", is deceptive, and its reasoning is unsound.

The problem with "consequential loss" is that investors are naturally prone to use the phrase in a commercial sense, and hence aggregate all financial losses (except net payments) as consequential loss. As discussed above, some of those losses may in fact be direct/Limb I, and hence pursuing a claim with losses wrongly classified as consequential, may inadvertently increase the evidential burden (ie the need to prove special circumstances/assumption of responsibility). While it is hoped such mistakes in terminology would not ultimately result in a less favourable outcome for an investor, it remains a very real risk.

PITFALLS

For many investors, the questions are simple:

(i) Will legal liability follow for the type of loss suffered; and if it does
(ii) which causes of action give rise to such liability (ie are those causes of action open to the investor); and
(iii) will there be liability for all or just part of the losses actually suffered.

Thus far, claims against banks for mis-selling pursued through the courts, have not enjoyed much success, and often face limitation difficulties (at least in relation to claims in contract).

In *Titan Steel Wheels v RBS*, the words "*in the course of carrying on business of any kind*" in the Financial Services and Markets Act 2000 were construed by Steel J as excluding Titan Steel from the category of "*private persons*" within s 150 (now s 138D) of the Act, which established a cause of action for breach of the Conduct of Business Sourcebook Rules. As such, the case removed breach of statutory duty as a cause of action available to most claimant businesses. Notably, Flaux J followed this construction of the Act in *Camerata Property v Credit Suisse*.

The practical effect is that businesses unable to claim such breaches of statutory duty will in many cases (where limitation issues bar a claim in contract) be limited to a tortious cause of action and/or a claim under the Misrepresentation Act 1967.

Mr Bailey's claim against Barclays (*Bailey v Barclays*) is another case highlighting many of the potential pitfalls for a business claiming mis-selling. Mr Bailey entered into a swap in May 2007, and by March 2009 interest rates had fallen so dramatically, he described the swap contract as disastrous. Rather than pay break costs to terminate the swap early, the swap was novated to Mr Bailey's company MTR, in April 2011.

On the bank's application to strike out the particulars of claim and/or for summary judgment, and MTR's cross-application to amend the particulars of claim, the judge held the company's claims failed entirely. The facts that led HHJ Keyser QC to this conclusion were unusual. MTR had acquired the swap via a novation (later argued as an assignment or partial novation). The novation destroyed any right in equity Mr Bailey may have previously had to rescind the original contract. As Mr Bailey accepted an offer of redress within the FCA agreed review (which – according to the judge – offered him "*substantially all of the relief that he sought to achieve in [the] proceedings*") his equitable claim for rescission fell away. The removal of Mr Bailey as a claimant also left MTR (as a company) unable to claim for breach of statutory duty, as a result of *Titan Steel*.

CUSTOMERS – NATURALLY ALWAYS ASKING FOR MORE

Claiming substantial consequential losses is far from a simple task without highly competent legal advice. Where claims are not taken through the courts, such advice is unlikely to be available to investors, and so the question remains as to how best to assist investors to understand and/or claim losses they have suffered, especially within the regulatory sphere.

While the benefit of fact-specific advice cannot be underestimated, claims management companies who have proliferated to fill the void of representation have not necessarily assisted investors to understand, calculate and recover their losses as quickly and accurately as may have been hoped.

Thankfully, judges are alive to the competing interests and forums in mis-selling, and many claims (perhaps issued as a protective measure) have been stayed to enable eligible investors to first participate in the FCA-agreed review. There has also been sensible use of standstill agreements to preserve the option of litigation more efficiently.

However, banks can only sensibly respond to claims on the basis they are formulated, and should not be expected to reformulate an ambiguous claim against their own interests. Accordingly, investors seeking legal advice on claims not pursued through the courts is far from extraordinary, and in many cases perfectly sensible.

For investors struggling to align their clams with their perceived consequential losses, the process inevitably remains a difficult one. Regrettably, in the absence of proper advice, they may continue to present as the proverbial Oliver Twist, empty bowl in hand, and a slightly sour aftertaste, regardless of the compensation received. ■

Further reading

- Compensating customers who have been mis-sold interest rate hedging products [2013] 8 JIBFL 507
- Damages for delay: generally a liability at large [2014] 5 JIBFL 291
- Lexis PSL: Financial Services: Exclusion and limitation of liability clause

Feature

KEY POINTS

- The remedies available to the victims of bribery are extensive.
- Those remedies have been significantly expanded recently by the Supreme Court in *Cedar Capital Partners LLC v FHR European Ventures LLP*, an example of a principal suing a bribed agent.
- The High Court case of *UBS AG v Kommunale Wasserwerke Leipzig Gmbh* illustrates what happens when the principal sues the payer of the bribe, in particular the importance of the remedy of rescission.

Author Duncan McCombe

"The safety of mankind": the civil consequences of bribery

This article reviews the English law on bribes with reference to the two recent cases of *UBS AG v Kommunale Wasserwerke Leipzig Gmbh* and *Cedar Capital Partners LLC v FHR European Ventures LLP.*

INTRODUCTION

The prevention of bribery is vital for the "safety of mankind", at least according to James LJ in *Parker v McKenna* (1874) LR 10 Ch App 96 at 124-125. This is perhaps hyperbolic, but it serves to illustrate the importance attached by the courts to the prevention of the practice.

Bribery for the purposes of English civil law was defined by Slade J in *Industries and General Mortgage Co Ltd v Lewis* [1949] 2 All ER 573 at 575:

> "For the purposes of civil law a bribe means a payment of a secret commission, which only means (i) that the person making the payment makes it to the agent of the other person with whom he is dealing; (ii) that he makes it to that person knowing that the person is acting as the agent of the other person with whom he is dealing; and (iii) that he fails to disclose to the other person with whom he is dealing that he has made that payment to the person whom he knows to be the other person's agent."

Therefore the case law that involves what can loosely be called "bribes" encompasses a broad range of behaviour. At one extreme it encompasses the behaviour of Warwick Reid who, as Acting Director of Public Prosecutions of Hong Kong, accepted bribes from criminals in order to obstruct their prosecutions (*Attorney General for Hong Kong v Reid* [1994] 1 AC 324). At the other end of the spectrum, is an agent who disclosed that he would be receiving a commission from the seller on a commercial deal, and who negotiated a significant reduction on the purchase price for the buyer, his client, but whose disclosure was deemed not to have been adequate (*FHR*, above). As far as English civil law is concerned, the remedial consequences of both ends of the spectrum are the same. Whether the agent in question was suborned or not is irrelevant, the mere taking of a bribe or secret commission is a breach of both the "no profit rule" and the "no conflict rule", and liability for breaches of those duties is strict.

Two recent cases illustrate the English court's approach to bribery from two different perspectives. *UBS AG v Kommunale Wasserwerke Leipzig Gmbh* [2014] EWHC 3615 (Comm) deals with the position as between the payer of the bribe and the wronged principal. *Cedar Capital Partners LLC v FHR European Ventures LLP* [2014] UKSC 45 is concerned with the position between the recipient of the bribe and the wronged principal. However, before these cases are explained, a general overview of English law in relation to bribes is necessary.

THE LAW ON BRIBERY

Bribery gives rise to a number of claims in equity and at common law. Taking equity first, the principal who has entered a transaction in which his agent has been bribed is on the face of it entitled to rescind the transaction, as long as *restitio in integrum* is possible. Although it is clear from the quote from *Lewis* above that the briber must know that the recipient of the bribe is the agent of the principal, it is not clear if any knowledge beyond that is required (see *Logicrose v Southend United Football Club* [1988] 1 WLR 1256 per Millett J at 1261).

Whether or not the wronged principal elects to rescind the contract, the bribed agent will be liable to account in equity for the amount of the bribe as profit received in breach of fiduciary duty. Similarly he will be liable to pay equitable compensation for any losses suffered by his principal by reason of the breach. Since *FHR*, discussed below, it is now also clear that the agent holds the bribe on trust for his principal as soon as he receives it. As far as the payer of the bribe is concerned, he may be liable for dishonestly assisting in the agent's breach of duty. (However, there is some debate about this, see *Bowstead & Reynolds on Agency* 20th Edn, p. 567-568.)

At common law, the principal will have a claim for unjust enrichment against his agent for the amount of the bribe. The agent is also likely to be liable in tort for any loss which his principal has suffered. Which tort is applicable will depend on the facts, although fraudulent misrepresentation and conspiracy are likely candidates.

The briber will also be liable at common law. If the wronged principal has suffered loss, the briber is (similarly to the agent) likely to be liable in tort; conspiracy, fraudulent misrepresentation and procuring a breach of contract being the most likely possibilities. Alternatively, it seems that the briber will be liable to the wronged principal for the amount of the bribe, even if the principal has suffered no loss. The basis of such liability is unclear (see *The Ocean Frost* (above) [1985] 3 WLR 640 per Robert Goff LJ at 743-745, *Logicrose* (above) at 1263; *Mahesan v Malaysia Government Officers Co-operative Housing Society Ltd* [1979] AC 374 per Lord Diplock at 383). However, as Lord Diplock said in *Mahesan* at 383:

> "This extension to the briber of liability to account to the principal for the amount of the bribe as money had and received, whatever conceptual difficulties it may raise, is now and was by 1956 too well established in English law to be questioned."

The wronged principal can claim the amount of the bribe from the briber or the recipient even though the contract has been rescinded (*Logicrose* (above) at 1262-1263 and as illustrated in *UBS* at [725]). However, if he sues for the amount of the bribe and losses incurred by virtue of the transaction, double recovery is precluded (*Mahesan* (above)). As between the briber and the recipient liability is joint and several (*Mahesan* at 383).

PRINCIPAL V BRIBER: *UBS*

The facts of *UBS* are complicated, mainly due to the complexity of the underlying financial transactions. The claim was brought by UBS which claimed payment of sums allegedly due to it from the defendant municipal water company of Leipzig (KWL) on the basis of a series of complex derivative products known as Single Tranche Collateralised Debt Obligations (STCDOs). According to Males J, "*The trial… revealed a sorry story of greed and corruption from which neither UBS nor KWL emerges with much credit.*"

The structure of the transactions was essentially as follows. In order to gain certain tax advantages under German tax law, KWL entered into a number of cross-border leases. KWL would lease its infrastructure to a special purpose vehicle ("the Trust") for which the Trust (funded by outside investors) would pay a premium up front. The Trust would then sub-lease the infrastructure back to KWL for rent which would provide a return for the Trust's investors. At the end of the term of the sub-lease KWL would have the option of re-purchasing the assets at a pre-determined price. The advantage of this for KWL was that the Trust would be domiciled outside Germany and would therefore, because of tax rules applicable in different jurisdictions, be able to take advantage of deductions for depreciation which KWL itself was not able to realise. This is what made the payment of the premium to KWL possible.

> "… it seems that the briber will be liable to the wronged principal for the amount of the bribe, even if the principal has suffered no loss… The basis of such liability is unclear…"

Part of the premium paid to KWL would be expended on infrastructure investment and running costs and part would be used to purchase bonds from a series of banks. The returns from these bonds would be used to pay the rent to the Trust and to re-purchase the assets when the time came. It was therefore crucial that the counterparties on these bonds did not default. In order to minimise the risk of such a default KWL entered into credit default swap agreements (CDSs) with UBS. However, in order to fund its obligations under the CDSs, KWL also entered into STCDOs with UBS (and two other banks, Depfa and LBBW) whereby it sold credit protection to the banks on a portfolio of entities. The banks would pay a regular premium to KWL for this, but the risk was that if a certain number of entities in the portfolio defaulted, then KWL would be obliged to pay a lump sum to the banks. In such a scenario, KWL's liability to UBS amounted to in excess of $150m. In the event, during the financial crisis, a sufficient number of entities in the STCDO portfolio defaulted, crystallising the liability of KWL, which UBS claimed.

The fact that a municipal water company was engaging in such complex financial transactions is surprising to say the least. As an internal email of one of the intermediary banks stated: "*You have to wonder what in the name of God a utility company were doing selling protection on this portfolio!! They must have been some persuasive UBS salesmen!!*" As it turned out, KWL was not so much influenced by persuasion as by corruption. KWL's managing director, Klaus Heininger, had taken a considerable bribe from an entity called Value Partners which had acted as KWL's financial adviser in the transactions.

KWL claimed, *inter alia*, that, although Value Partners was KWL's own agent, Value Partners' relationship with UBS, and in particular with UBS's employee Steven Bracy ("*a thoroughly dishonest man*" according to Males J), was so close that it was also acting as agent for UBS. If this was so, the bribe paid by Value Partners could be said in law to have been paid by UBS. On that basis, it was claimed that KWL was entitled to rescind the STCDOs and avoid liability. Males J found (at [591]-[608]) that Value Partners was to be treated as the agent of UBS, was acting within the scope of its agency when the bribe was paid (at [609]-[620]), and therefore (at [588]) that KWL was entitled to rescind the STCDOs:

> "Where the agent of one party to a contract pays a bribe to the agent of the other party, the party whose agent was bribed is entitled to avoid the contract (and claim damages from the principal of the agent who paid the bribe)."

This was based on the authority of *The Ocean Frost* (above) at 743-745. It was therefore unnecessary for KWL to show

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that UBS itself authorised the bribe, or even knew about it, as it was to be held responsible for the acts of its agent (at [589]). The STCDOs were therefore to be rescinded, UBS's arguments that rescission would be disproportionate and that KWL did not come to the court with clean hands were rejected (at [697]-[708]).

This then raised the problem of how, from a practical perspective, financial transactions as complicated as the STCDOs were to be unwound. Males J's judgment at [717]-[731] is an excellent example of the way in which a court goes about such an exercise in practical terms.

"... it appears that no limitation period would now apply where the principal seeks to recover a bribe from his agent, or indeed to any claim for the recovery of a benefit derived from a breach of fiduciary duty"

PRINCIPAL V BRIBEE: *FHR*

The issue at stake in *FHR* was described by Sir Terence Etherton C as provoking a "*relentless and seemingly endless debate*" (*The Legitimacy of Proprietary Relief* (2014) Birkbeck Law Review vol 2(1) 59 at 60), and by Pill LJ in his judgment in the Court of Appeal as "*revealing passions of a force uncommon on the legal world*". After the Supreme Court's judgment in *FHR*, the debate is over and passions can be calmed.

The case concerned the sale of the Monte Carlo Grand Hotel. After the sale it emerged that the buyer's agent had been paid a commission by the seller, which had not been sufficiently disclosed. The point at issue on appeal was whether such a commission taken in breach of fiduciary duty attracts a proprietary remedy or whether liability is merely personal. Their Lordships opted categorically for the former and decided that a bribe or secret commission received in breach of fiduciary duty is held on trust for the principal. Indeed, their Lordships (at [35]) decided that "*any benefit acquired by an agent as a result of his agency and in breach of his fiduciary duty is held on trust for the principal*".

In doing so, their Lordships overruled the House of Lords authority of *Tyrrell v Bank of London* (1862) 10 HL Cas 26 and the longstanding Court of Appeal cases of *Lister & Co v Stubbs* (1890) 45 ChD 1 and *Metropolitan Bank v Heiron* (1880) 5 ExD 319, preferring the approach adopted by the Privy Council in *Reid* (above). Even more remarkably the Supreme Court, for whom Lord Neuberger PSC gave the leading judgment, also overruled the recent Court of Appeal authority of *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd* [2012] Ch 453, in which Lord Neuberger MR gave the leading judgment. In *Sinclair* Lord Neuberger (at [76]) elected to follow *Lister* and *Heiron* in preference to *Reid* stating that: "*Although it is possible that the Supreme Court would follow the Reid case rather than the Heiron and Lister cases, I am far from satisfied that they would do so. In any event it does not seem to me right to follow the Reid case.*"

What changed Lord Neuberger's mind? The simplicity of the respondent's position was seemingly attractive: "*Subtle distinctions are sometimes inevitable, but in the present case… there is no plainly right answer, and, accordingly, in the absence of any good reason, it would seem right to opt for the simple answer*" (at [35]). Policy considerations in favour of discouraging bribery where "*concern about bribery and corruption generally has never been greater than it is now*" also played a role (at [42]). Finally, the fact that most common law jurisdictions have preferred *Reid* was also persuasive: "*it seems to us highly desirable for all those jurisdictions to learn from each other, and at least lean in favour of harmonising the development of the common law around the world*" (at [45]).

This decision has a number of consequences. Any benefit received by a fiduciary "*as a result of*" his fiduciary relationship will now attract a proprietary remedy. The benefit can now therefore be traced in equity into investments or into the hands of others. Additionally, the claim for any such benefit will be prioritised above those of unsecured creditors in an insolvency. Depending on the circumstances, the claimant's right to that benefit could also be prioritised above those holding other equitable proprietary rights, such as equitable charge holders. Limitation will also be affected; it appears that no limitation period would now apply where the principal seeks to recover a bribe from his agent, or indeed to any claim for the recovery of a benefit derived from a breach of fiduciary duty.

CONCLUSION

It can therefore be seen that the remedies available to a claimant whose agent has been bribed are considerable. This might be considered harsh on UBS; in many ways it was a victim of its employee's dishonesty in a similar way to KWL. Likewise, in *FHR* the defendant was penalised even though there was no proof of any corruption and the claimant made a large profit on the deal. This strictness is justified by the courts on the basis of "*wider policy considerations*" concerning the moral impropriety involved in bribery (*FHR* per Lord Neuberger at [42]), a point specifically referred to in *UBS* (at [578]). The odds, it would seem, are stacked firmly against defendants in such cases. ■

Further reading

- FHR European Ventures LLP: the demise of *Sinclair v Versailles* and a welcome return to orthodoxy [2014] 5 CRI 175
- *FHR European Ventures v Cedar Capital*: a decision with wider implications for the loan market? [2014] 11 JIBFL 717
- LexisNexis Loan Ranger blog: Fraud, bribery, misrepresentation and corruption – derivatives contract set aside

KEY POINTS

- Agency underpins the relationship between an asset manager and its client – the duty to act in the best interests of the client is necessarily a part of that duty.
- The duty to act with due skill and care is a component of the agency principle alongside the fiduciary duty of loyalty, to avoid conflicts of interest and not to profit from one's position.
- Breach of an agent's duties may give rise to liability both for the firm and individuals within the firm with the client having remedies in damages and equitable remedies.
- With a clear exposition of the agency principle in *SPL Private Finance* and the FCA rules implementing the UCITS Directive, the AIFMD and MiFID, further rules on the duties of asset managers seem unnecessary.

Author Andrew Henderson

Asset manager liability: fleshing out the "good agent" principle

In its 2014 Business Plan, the Financial Conduct Authority (FCA) declared that it would "ensure that asset managers are acting as good agents and taking proper account of investor interests".[1] What it means for an asset manager to be a "good agent" was recently explored by Mr Justice Walker in *SPL Private Finance (PFI) IC Ltd v Arch FP LLP* [2014] EWHC 4268 (Comm).

The decision in *Arch* provides a rare restatement of the liability of asset managers in English law. Although, with the conduct in *Arch* having been the subject of a Financial Services Authority Decision Notice,[2] *Arch* should be seen as shining a light on existing regulatory principles rather than creating supplementary principles. Indeed, *Arch* highlights the fact that the "good agent" principle is more an amplification of existing regulatory rules and principles rather than a new principle. Further legislative or regulatory exposition should be unnecessary.

BACKGROUND

Arch managed the Arch-Cru funds which were constituted as cells of a Jersey incorporated cell company. A number of those funds brought claims against Arch and its CEO in connection with investments made by Arch on behalf of the funds in a student housing business known as Club Easy. The funds claimed that the decisions to make these investments were driven by Arch's financial interest in obtaining illegitimate payments, in the form of £6m of fees on a £20m investment, rather than proper consideration of the investments' merits and the interests of the funds. They also alleged that Arch acted in breach of fiduciary duty, in breach of contract and negligently and that the CEO dishonestly assisted Arch to breach its fiduciary duties and induced its breaches of contract.

AGENCY AS THE FOUNDING PRINCIPLE

Upholding the claims, the judge held that:

- The agency principle is the founding principle in determining a manager's duties and includes a duty to use due care when exercising discretion. In the absence of any contractual term to the contrary, a firm's role as agent carries with it a duty to exhibit such a degree of skill and diligence as is appropriate to the performance of the duties accepted.[3]
- Where a firm, as agent, undertakes to act for its client in circumstances giving rise to a relationship of trust and confidence, that firm owes duties of loyalty to give preference to the client's interests over the firm's own interests. These duties are usually referred to as "fiduciary duties".[4]
- There are two supplemental duties which reinforce the duty of loyalty. These are the duty of the firm, as agent, to avoid conflicts, or potential conflicts, of interest, and the duty not to profit from its position. These are special fiduciary duties which operate strictly, without proof of intentional wrongdoing or even fault.[5]
- A client's consent to a firm's acts will be a defence to a claim for breach of the duties of loyalty. However, this will only be the case if the firm has made full disclosure of all the material facts and the nature and extent of the firm's interest.[6]

The duties above to require a necessary degree of care require a risk/reward analysis. In *Arch*, no evidence was produced of a risk/reward analysis having been performed. As there was no such analysis, the judge found that Arch was negligent in relying on property valuations without taking account of obvious problems within the Club Easy business.

> "As there was no such [risk/reward] analysis, the judge found that Arch was negligent in relying on property valuations without taking account of obvious problems within the Club Easy business"

IMPORTANT DISTINCTIONS

The judge held that the firm/client relationship had to be understood in the context of the contractual documentation between the parties per *JP Morgan Bank v Springwell Navigation Corp* [2008] EWHC 1186 (Comm). Unlike *Springwell*, which concerned a commercial transaction with no expectation that the firm would act in the best interests of its client, the investment management agreement between the funds and Arch governed Arch's exclusive control of the funds assets. Acting in the best interests of the funds lay at the heart of the Agreement.[7]

Rejecting the claim for breach of mandate, the judge observed that, although it depends on the scope of the mandate set out in an investment management agreement or elsewhere, a mandate which is determined by reference to, for example, "medium to long term... capital appreciation through an economic exposure to a diverse range of investments in private finance selected by the investment manager" should not be read as including a requirement that the mandate be confined to investments which are "likely to" produce such a result. Rather the question of adherence to such a mandate is an objective one determined by asking whether or not a particular investment would provide capital appreciation over the medium to long term.[8]

"The judge observed that a contractual provision may limit a firm's fiduciary or equitable obligations to its client by giving a firm the freedom to act for other clients in situations which may give rise to a conflict of interest"

INDIVIDUAL LIABILITY, SCOPE OF LOSS AND EQUITABLE REMEDIES

In upholding the claims against Arch's CEO, the judge affirmed that:

- An individual manager employed within a firm will be personally liable for dishonest assistance where: (a) he/she knows there is a contract; (b) he/she intends to induce a breach of the contract; and (c) his/her conduct causes an actual breach of the contract. As to (b), if the manager acts in good faith as part of his relationship with the firm and within the scope of his/her authority, then a claim for inducing breach will not succeed.[9]
- If a client's loss is within the scope of the firm's duty, the client will be able to recover the entire loss. Following *South Australian Asset Management Company v York Montague*,[10] this will include including any element arising from matters unconnected with the breaches of duty but is subject to: (a) the actual loss exceeding the losses that would have been made on alternative investments had the firm discharged its duties; (b) the client having taken reasonable steps to mitigate its loss – the standard of reasonableness not being high; and (c) a causal relationship between the breach of duty and the loss suffered existing as a matter of fact.[11]
- Where a firm breaches a fiduciary duty, a client may also have equitable claims against the firm. In this respect, the judge confirmed that equitable compensation can be recovered for breach of the fiduciary duties, provided that it is shown that but for the breach, the beneficiary would not have acted in the way which has caused loss. The firm may also be subject to equitable claims based on proprietary interest, accounts and enquiries and restitutionary claims.[12]

REGULATORY PRINCIPLES AND CONTRACTUAL DUTIES

The judge observed that a contractual provision may limit a firm's fiduciary or equitable obligations to its client by giving a firm the freedom to act for other clients in situations which may give rise to a conflict of interest. However, he held that any such limitation is subject to (what is now) FCA Principle for Businesses 8, which requires a firm to manage conflicts fairly.

Reliance on Principle 8 is the only material use of a regulatory rule[13] in the judgment to elucidate a fiduciary or equitable obligation or, more accurately, contextualise and restrict the limits on that obligation by contract. Where the limits of a contractual power require testing, a firm's obligations under the regulatory system help determine those limits or the manner in which the firm should exercise its discretion under that contract.

At first blush, regulatory rules may appear complimentary – used to fill in the gaps. However, for a regulated firm regulatory rules necessarily give content to the duties under a contract. This was clear in, for example, *Brandeis Brokers v Black and Others* where Toulson J held that Securities and Futures Authority rules were a guide in determining whether the defendant firm had met the standards which the claimant clients were entitled to expect.[14]

Moreover, an asset manager's breach of its regulatory duties to "act honestly, fairly and professionally in the best interests of its client" in COBS 2.1.1, when (a) managing a UCITS fund or (b) managing a segregated account or providing some other service to which MiFID applies are directly actionable on the basis of breach of statutory duty. In this respect and unlike the Principles for Businesses, COBS 2.1.1 is directly actionable under FSMA, s 138D (claims for damages), something often forgotten by firms and their advisers alike.[15] COBS 2.1.4 which applies to AIFMs is broader, copying out the requirements of Art 12 of the AIFMD. It requires AIFMs to: "act honestly, fairly and with due skill care and diligence in conducting their activities; act in the best interests of the AIF it manages or the investors of the AIF it manages and the integrity of the market; treat all investors fairly; and not allow any investor in an AIF to obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF's instrument constituting the fund". Like COBS 2.1.1, it is directionally actionable.[16]

Questions regarding the directly actionable duties in COBS 2.1.1 and 2.1.4 together with the indirectly actionable duties under Principles 1 (integrity) and 2 (skill, care and diligence) did not arise in the judgment.[17] However, the judge had sufficient and clear grounds for establishing liability on established common law and equitable grounds.

While the FCA's reliance on the "Good Agency Principle" foreshadowed its consultation on the use of dealing

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commission,[18] the principle lies at the heart of the FCA's current policy on asset managers.[19] With the restatement and application in *SPL Financing* of the legal rules and principle governing an asset manager's liability as agent and the plethora of existing regulatory rules and principles implementing the UCITS Directive, AIFMD and MiFID,[20] the need for further FCA rules would seem unnecessary. Of course, as *SPL Financing* and, indeed, the FSA enforcement action arising from the same events, show, the FCA can claim that there is still and perhaps will always be work to do in ensuring compliance with those rules.[21] ■

> "While the FCA's reliance on the 'Good Agency Principle' foreshadowed its consultation on the use of dealing commission, the principle lies at the heart of the FCA's current policy on asset managers"

1 FCA Business Plan 2014/15, p 24.

2 *FSA v Arch Financial LLP*, Decision Notice 14 September 2012, www.fsa.gov.uk/static/pubs/decisions/arch-financial-products.pdf.

3 See para 171.

4 See para 172. Although it is not noted in the judgment, not every duty owed by an agent is a "fiduciary duty". For example, a simple duty to account is not a fiduciary duty even when it is owed by a fiduciary but rather a contractual duty. (See *Coulthard v Disco Mix Club Ltd and others* [1999] 2 All ER 457 (Ch).)

5 *Ibid*.

6 See para 182.

7 See para 173 *et seq*.

8 See para 272.

9 See para 278 *et seq*.

10 [1997] AC 191.

11 See para 327.

12 See paras 347 *et seq* and 354 *et seq*.

13 Nomenclature notwithstanding, the FCA's Principles are regulatory rules. (See PRIN 2.1.1 together with *The Readers Guide*, Ch 6.)

14 [2001] 2 Lloyd's Rep 359, at 363, col 2. See also Marshall, 'Interest rate swaps and the sale of the unknown', [2014] 1 JIBFL 9, which highlights the recent failure of the courts to apply the *Brandeis* decision in the context of banking relationships.

15 See COBS Sch 5.4 and the FSMA (Rights of Action) Regulations 2001 (SI 2001/2256). The partial disapplication of the fair, clear and not misleading rule in COBS 4.2.6 does not extend to COBS 2.1.1.

16 Ibid.

17 Breaches of Principles 1 and 2 are cited in FSA Decision Notice (fn 2 *supra*) at paras 5.2 *et seq*.

18 See CP 13/17, particularly s 1: "This Consultation Paper forms part of our wider asset management strategy, which focuses on ensuring [*sic*] investment managers, acting as agents on behalf of their clients, put the customer's best interests at the heart of their businesses."

19 *Ibid*.

20 Which MiFID II and UCITS VI and AIFMD II following MiFID II (See, eg, ESMA's comments in the context of product governance in its Technical Advice to the Commission on MiFID II and MiFIR, 19/12/1, Ch 2.7, para 9.)

21 At the time of writing an Upper Tribunal decision in respect of the FSA Decision Notice (fn 2 *supra*) was still expected.

Further reading

- Interest rate swaps and the sale of the unknown: blind alleys, an enfeebled equity and the triumph of certainty over fairness [2014] 1 JIBFL 9
- Disloyalty in the UK capital markets: investment intermediaries and fiduciary duties [2014] 2 JIBFL 98
- Lexisnexis financial services blog: SEC review of money market funds: what's the potential impact?

Feature

KEY POINTS

- Increased regulation and stricter capital requirements on European banks have encouraged the deleveraging of balance sheets, causing a shortfall in the availability of capital and liquidity in the financial markets.
- Since the financial crisis, non-bank credit funds have emerged to bridge the funding gap in both the primary and secondary loan markets.
- Regulation of non-bank lending has proved a complex challenge for credit funds and other alternative lenders.
- The documentation and market practice within the loan origination and trading worlds designed with banks in mind will increasingly need to address a number of legal issues in order to facilitate the continued growth of credit fund lending.

Authors Karl Clowry and Christian Parker

A seat at the table? Ways to adapt loan documentation to accommodate credit fund lenders

This article examines how credit funds can navigate the legal and regulatory structures designed for bank lending and how credit documentation and practice have sought to accommodate this source of funding within the existing market-accepted forms of loan documentation. In turn, this should facilitate the diversification and liquidity of European credit markets while matching credit fund investors' requirements for appreciable returns. We note at the outset the distinction between the widely syndicated and relatively liquid leveraged loan market and the generally un-syndicated and illiquid direct lending and unitranche financing market. The tax implications of credit fund lending warrant a fulsome discussion in their own right and, as such, are not addressed here.

The European Central Bank estimates that lending to non-financial corporations declined by 12% from its peak in January 2009 to March 2014 (European Central Bank's *Bank Lending Survey*, April 2014). Simultaneously, demand for corporate credit in the UK continued to increase in 2014 with the rate of decline in the overall stock of lending to non-financial businesses beginning to ease, but still below pre-crisis levels (see the Bank of England's quarterly publication, *Trends in Lending*, for 2014 and January 2015). In addition to new regulatory requirements such as Basel III, the fall-out from the financial crisis has encouraged European banks to deleverage their balance sheets, following several years of sustained provisioning for impaired assets. This trend will likely be accelerated by the European Central Bank's Asset Quality Review[1] that was completed in October 2014 and is widely expected to result in increased provisioning and, importantly for the non-bank lending community, the increased disposal of loan assets by the affected banks. This has created real debt purchase opportunities for non-bank lenders.

Against this backdrop, new institutional lenders as well as credit funds have emerged as a potentially transformative and increasingly critical source of liquidity, typically looking for synergies between the financing opportunities available and their own investment strategies and risk profiles, with certain sub-funds looking to exploit opportunities in particular areas. Certain of these credit funds have emerged as alternative financiers for high-profile acquisitions, often working with other credit funds focussing their attention on opportunities in real estate and infrastructure, frequently involving a turnaround/credit event/distressed opportunity driven strategy.

THE REGULATORY ENVIRONMENT

At the same time that the market has been crying out for more lending, and the positive direction of travel of some regulators has been to encourage the growth of alternative sources of finance, others in the politico-regulatory complex have been layering a more onerous regulatory burden on those seeking to fill the void left by many traditional lenders.

Banking licences

The UK has long been at the liberal end of the banking regulatory spectrum such that it has generally maintained the principle that banking regulation should focus on the protection of depositors rather than deposit takers and borrowers.[2] Although this principle over the last few years has been disrupted by the increasing regulation of the "peer-to-peer" and "pay-day lending" market, the basic principle remains that lending to corporate borrowers remains an unregulated business in the UK. That is not the case throughout Europe where, in a number of significant jurisdictions (France, Italy, Germany and others), local legislation ensures that "lending" is a regulated activity, meaning that (if a credit fund is to engage in the activity in an applicable jurisdiction) it either needs to secure for itself a banking licence or engage in a "work-around" often at the cost of higher withholding tax charges (many of which are well established but, from a credit fund's and their investors' perspective, time-consuming and costly).

Shadow banking

The expression "shadow banking" was developed at a G20 meeting in April 2009 as a term for "the system of credit intermediation that takes place outside the regular banking system" in the wake of the

Lehman crisis and has been the focus of intense scrutiny ever since, led primarily by the Financial Stability Board and the EU. The key plank of prospective "shadow banking" regulation that should concern the non-bank lender is the focus on entities that might include "investment funds… that provide credit or are leveraged".[3] For the time being the "shadow banking" regulatory focus has been on money market funds and securities financing, with non-bank lenders off the immediate agenda. However, the initiative still potentially hangs over the non-bank lending market.

UCITS[4] and AIFMD[5]

In Europe the fund markets are divided into the public/retail (UCITS) and the sophisticated/institutional (AIF). Whereas, despite some intense lobbying (and some aggressive interpretation of the UCITS rules by some managers), the UCITS market remains closed to the acquisition of corporate loans, the AIF regime has facilitated the establishment of loan funds that, if established in the EU, will be able to benefit from the AIFMD "passport" and be marketed freely across Europe at least to sufficiently "qualified" investors. Ireland has adopted special rules for loan originating AIFs[6] and Luxembourg's pragmatic approach to the same market sector means that this regime at least is likely to remain open and encouraging to the credit fund sector. Other EU initiatives (for example European long term investment funds (ELTIFS)[7] – which have been heavily politicised, being restricted to infrastructure and "socially useful" loans) show some promise but, until the EU finds a way to open the corporate loan market more broadly to retail investors (as in the United States), the broader corporate loan market will remain substantially an institutional market (arguably to the detriment of the retail investor).

SYNDICATION AND THE SECONDARY LOAN MARKET: LEGAL ISSUES

The changing loan syndication market, the burgeoning EU secondary loan trading market and the arrival of new credit fund participants have together focused attention on the need to accommodate non-bank credit fund lending within existing documentary structures. In this section, we explore a number of selected legal issues and methods for removing the barriers to entry for credit funds in the primary and secondary loan markets.

> "We therefore expect few credit funds to participate in revolving facilities, though it should be noted that a number of term facilities also permit repayment and redrawing to reduce interest expense…"

Nature of the participation

As described above, legislative regimes in certain European jurisdictions necessitate credit fund involvement principally in the secondary loan markets or via fronting bank/sub-participation arrangements. With the number of willing fronting banks declining in recent years, sources of financing in a number of these jurisdictions have been curtailed further. However, there exist increasing opportunities for credit funds to participate in so-called "unitranche" facilities (being single tranche facilities with a variety of possible structures depending upon the needs of the borrower, the fund origin and the sector concerned). Such facilities present borrowers and lenders alike with minimal syndication risk, lower costs of capital, and greater speed and certainty of execution. Typically the borrower will negotiate with one lead lender, with the borrower not party to the "agreement among lenders" which is the instrument that can cater for the variations from the existing documentary restrictions and market practices that credit funds seek; this effectively slices a single loan into two or more tranches with different margins and priorities of recovery.

Typically, a credit fund will not possess the administrative infrastructure to deal with numerous repayments and drawings. We therefore expect few credit funds to participate in revolving facilities, though it should be noted that a number of term facilities also permit repayment and redrawing to reduce interest expense, particularly those involving strong private equity sponsors. An important consideration for any credit fund at the outset of any investment decision will be to understand its obligations in this regard and to judge whether it can perform the functions required by repayment and redraw, and whether such facilities align with its investment strategy/reinvestment horizon?

There also exists the opportunity for credit funds to develop the capabilities to administer revolving facilities, though this may attract unwanted regulatory intrusion should such funds begin to resemble and engage in traditional bank-like activities and bring them potentially closer to needing a banking licence. In the context of unitranche funding, the participation by credit funds in facilities involving a revolving component can be accommodated by providing for any revolving facility to be provided by a bank lender on a super senior basis, with the fund only participating in a term loan facility.

Lender of record and relationship with facility agent

The lender of record under the facility is ostensibly responsible for issuing instructions to the facility agent. Certain credit fund structures are required by law to have in place a custodian to "hold" their assets, or an investment fund manager to actively manage the assets on behalf of the fund. For example, under the AIFM Directive the "depositary requirement" means that a service provider will be overseeing the holding of loans that by their nature cannot easily be custodied. To ensure tax efficient investment, this will often be combined with a special purpose vehicle to act as a "tax blocker" through which the fund ultimately invests. Where the latter type of entity is used then it will be the lender of record with an appropriate tax residence to minimise withholding tax arising on interest payments made under the loan. Issues may arise regarding which entity has the ability to instruct/indemnify the facility agent. Even where the fund itself is named as lender of record it will typically act via an investment manager, acting under an investment management agreement.

> "A question that sometimes arises is whether a closed-ended fund with limited access to free capital can provide an acceptable indemnity to the facility agent and security trustee"

Prior to the fund becoming a lender a facility agent will undertake appropriate "know-your-client" verification to ensure it has a clear understanding of which entity is the lender of record and from whom it may accept instructions. In some instances, where a fronting bank is being used as lender of record it may receive conflicting instructions from its sub-participants and should ensure that applicable sub-participation agreements provide that the lender of record may provide or withhold its consent depending on the majority instructions from its sub-participants and subject to a reputational carve-out for taking certain action. An alternative for any such credit fund as sub-participant would be to "elevate" and become lender of record, though it should be noted that this could lead to adverse tax implications in a number of jurisdictions.

Indemnities

In consideration for their administration of the facility, facility agents and security agents/trustees will demand indemnification for their costs and liabilities by each lender, in addition to that provided by the obligors. A question that sometimes arises is whether a closed-ended fund with limited access to free capital can provide an acceptable indemnity to the facility agent and security trustee.

There is not usually a legal impediment that would prohibit such an indemnity being given; many entities with defined exit strategies in the secondary market are capable of providing satisfactory indemnities at present. Another consideration which flows from this is the tenor of the fund and any contingent liability that the fund might have (and be required to make provision for beyond its scheduled maturity) following the sale of its participation. However, as it must liquidate its investments prior to its own maturity then the indemnification obligation can be transferred as part of the underlying debt trade.

The liquidity of the relevant fund's assets and its size should ordinarily determine how attractive an indemnity it can provide (with the need for any limitation of liability clause becoming less relevant the larger the fund and the more liquid the fund's assets are). To account for a scenario where a facility agent and security trustee cannot obtain sufficient comfort as to all lenders' creditworthiness, then loan documents can be amended to provide for priority in the waterfall of payments to be afforded to those lenders capable of providing the requisite indemnity. In the context of the secured status of senior leverage loan transactions, pre-funding to back a fund lender's indemnity has not been as prominent an issue as in the unsecured high yield bond market.

It should be noted that administrative loan parties are beginning to require ever wider indemnities as a reaction against more creative causes of action arising against facility agents. In the United States such parties have faced claims for aiding and abetting directors to breach their fiduciary duties by agreeing to include dead-hand change of control provisions in loan agreements (see *In Re Comverge, Inc Shareholders Litigation* CA No 7368-VCP (Del Ch Nov 25, 2014) where such a claim was dismissed, and *Pontiac General Employees Retirement System v Healthways, Inc* CA No 9789-VCL (Del Ch Oct 14, 2014) where the court allowed the plaintiffs' aiding and abetting claim to survive a motion to dismiss). Despite this trend, in Europe, the scope of such indemnities has largely remained the same, with the usual exculpations for fraud, gross negligence and wilful misconduct.

Assignments, transfers and borrower restrictions

The Loan Market Association's standard terms and conditions provide for the transferability of all or part of a loan, by assignment or novation to:

> "any kind of financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets…"

Standardised documentation (such as that produced by the LMA) will also provide for a form of restriction, consent and/or consultation right in respect of any assignment or other transfer to certain entities. Issues can arise, however, when borrowers and lenders seek to define those entities to whom transfer of a participation is prohibited. In the case of *Essar Steel Ltd v The Argo Fund Ltd* [2006] EWCA Civ 241, the Court of Appeal interpreted the expression "financial institution" widely. The loan contract in question provided that any transferee had to be a "bank or financial institution", which the Court of Appeal ruled could be construed to include an institution such as Argo, not involved in bank-like activities.

To avoid hindering the ability of credit funds looking to participate on a "take and hold" basis, borrowers wanting to

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restrict the involvement of opportunistic distressed debt funds known to pursue aggressive enforcement strategies, have three options. First, by the inclusion of borrower consent rights for any transfer in the facility, secondly, by seeking to include a definition of "distressed debt fund", or thirdly, the borrower could prepare a list of specific institutions (and their affiliates or related funds, where applicable) to whom transfers are restricted. Each option presents difficulties, but certain sponsors in the market would welcome a definition of "distressed debt fund" centred on the primary purpose for the acquisition of any participation (being, opportunistic below par acquisitions made with the intention of short term gain or to gain an ownership stake through enforcement of security). That said, it is standard practice that any transfer restriction that a borrower may have negotiated into its facilities will cease to apply if the borrower is in default.

Prepayments

As noted above, credit funds will typically have a defined investment horizon. Allocating capital to a loan usually involves drawing a commitment from a fund for a set period in anticipation of an expected return. Investment funds would ordinarily be willing to accept mandatory prepayment given the circumstances under which such provisions are triggered.

In the absence of significant structural or credit events concerning a borrower, voluntary prepayment (favoured by borrowers) is a feature of most facilities. A common feature of unitranche facilities involves prepayment prohibitions (often in the first two years of the facility). One method for resolving this issue could involve the tranching of debt, with credit funds participating only in those tranches prohibiting voluntary prepayment.

> "To avoid hindering the ability of credit funds looking to participate on a 'take and hold' basis, borrowers wanting to restrict the involvement of opportunistic distressed debt funds… have three options"

CONCLUSION

As companies innovate and change, regulators and lawyers alike will have to find ways to adapt accordingly and balance the risks and complexities posed by non-bank lending with the benefits associated with the provision of credit to viable companies in an environment where banks are unable to provide the liquidity required. Removing the barriers to entry for credit fund involvement in both the primary and secondary loan markets will create the conditions under which this transformative and increasingly critical source of liquidity can thrive. ■

1 See https://www.bankingsupervision.europa.eu/ecb/pub/pdf/aggregatereportonthecomprehensiveassessment201410.en.pdf.

2 See the Breedon Report: https://www.gov.uk/government/publications/improving-business-access-to-finance.

3 See: http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf.

4 See: http://ec.europa.eu/finance/investment/ucits-directive/index_en.htm.

5 See: http://eur-lex.europa.eu/LexUriServ/LexUriServ.o?uri=OJ:L:2011:174:0001:0073:EN:PDF.

6 See, for example, http://www.centralbank.ie/press-area/press-releases/Pages/CentralBankpublishesnewrulesonloanoriginatingQualifyingInvestorAIFs.aspx.

7 See: http://ec.europa.eu/finance/investment/long-term/index_en.htm.

Further reading

- Alternative credit providers in Europe [2014] 9 JIBFL 584
- Borrowing from a fund: 10 points to watch out for in LMA documentation [2013] 8 JIBFL 516
- LexisNexis Loan Ranger blog: Non-bank lending options for UK corporates – two years after Breedon

KEY POINTS

- English schemes of arrangement were used successfully in 2014 to restructure the debts of two French companies.
- Schemes can, in appropriate circumstances, provide an alternative to French *sauvegarde* proceedings where there is a sufficient connection with England.
- There are various routes to obtaining recognition of schemes in the French courts.

Authors Emma Gateaud, Richard Tett and Katharina Crinson

"*La scheme à la française*": a new restructuring tool for French debtors

This article explains that French debtors can now use English schemes of arrangement, discusses the recognition of schemes in France and outlines the issues to consider when choosing between an English scheme and a French safeguard proceeding.

Last year was a prolific year for the French restructuring legal landscape. On 1 July 2014, France saw a number of reforms, including the introduction of the *sauvegarde accélérée* (the new accelerated safeguard proceedings), an extension of the new money privilege for creditors providing new lending during pre-insolvency proceedings and a new right for bank creditors to propose a safeguard plan to a company. At the time of writing, a much-anticipated new law is also before the French parliament. This law, if implemented would allow debt for equity swaps without shareholder consent, in limited circumstances, thus preventing out of the money shareholders from blocking a restructuring.

2014 was also the year in which France opened its door for the first time to English schemes of arrangement. Two French companies successfully restructured their debts with a scheme of arrangement: Zlomrex International Finance SA ("Zlomrex"), a *société anonyme*, ([2013] EWHC 4605 (Ch)) which completed in February 2014 and Zodiac Pool Solutions, Zodiac European Pools SAS and Zodiac International SAS ("Zodiac"), all *société par actions simplifiées*, which completed in July 2014 ([2014] EWHC 2365 (Ch)).

French corporates now have a much broader spectrum of restructuring tools available to them. Going forward, French debtors should consider what restructuring tool is the most appropriate in the circumstances. Schemes will not always be available (see below the requirement for a "sufficient connection" with England) and both English schemes and French safeguard proceedings should be compared when deciding how to implement a restructuring.

SAFEGUARD PROCEEDINGS OR SCHEMES OF ARRANGEMENT?

Safeguards have a lower threshold of creditor approval (two-thirds of each class of creditors) than schemes, however the constitution of creditor committees/classes is not the same as in schemes. In a French safeguard, all bank debt holders will vote together (including senior and junior and unsecured and secured), and bondholders will also vote together in one assembly (separate to the bank debt committee), regardless of secured status or priorities. An English scheme will, by contrast, require creditors with different rights to vote in separate classes. Depending on the commercial solution required, the company may find that the constitution of creditor classes is an important factor in choosing the restructuring tool.

A scheme may be advantageous in circumstances where a safeguard would trigger defaults in finance documents. Schemes are a statutory process arising under the English Companies Act 2006, not the Insolvency Act 1986. Depending upon the drafting of the finance documents, schemes may not trigger an insolvency default.

Finally, while the new *sauvegarde accélérée* has been used at least once since its introduction (Alma Consulting), schemes of foreign companies are more commonly used and are a tried and tested tool over many years for complex and innovative restructurings.

THE REQUIREMENT FOR SUFFICIENT CONNECTION WITH ENGLAND

In recent years, many companies incorporated outside of England have implemented English schemes of arrangement (for example companies incorporated in Austria, Denmark, Finland, France, Germany, Indonesia, Ireland, Italy, Jersey, Kuwait, the Netherlands, Norway, Russia, Singapore and Vietnam).

It is well established in England that foreign companies can avail themselves of the English scheme of arrangement process, where the English court is satisfied, among other conditions, that there is a "sufficient connection" with England.

The English courts have found a "sufficient connection" where the relevant debt (creating the debtor/creditor relationship which is the subject of the scheme) is governed by English law and subject to an English jurisdiction clause (exclusive and non-exclusive). This was the requisite link with England, for example, in

WHAT IS A SCHEME?

A scheme of arrangement is a consensual cram down mechanism usually proposed by a company to its creditors. It is a very flexible tool to effect a commercial compromise or arrangement between the company and its creditors where unanimous consent of creditors cannot be obtained. A scheme can be used to amend, release or write-off debt and put in place new debt/equity instruments.

A scheme will bind all the scheme creditors if approved by 75% in value and a majority in number of each class of creditors who vote at the scheme creditor meetings and provided that the English court also sanctions the scheme.

It does not have the stigma attached to insolvency processes because it is an English company law process. Schemes are commonly used to implement restructurings of both English and foreign companies. It is a particularly useful tool where unanimous consent of creditors is difficult to obtain.

the scheme of the French companies, Zodiac.

In more recent cases, English courts have also found the requisite "sufficient connection" where the relevant debt was governed by foreign law but the centre of main interests (COMI) of the company had been shifted to England (for example, the New World Resources scheme in 2014 and the Magyar Telecom scheme in 2013). A French company, Zlomrex, also shifted its COMI to England to provide the sufficient connection for the scheme because its debt documents were governed by New York law, not English law. Shifting the COMI of a company to England should not be difficult where the debtor is a holding company of the group and has no or limited operations in France. There is no minimum time for corporates to shift their COMI prior to a scheme (although the court will consider carefully whether the centre of main interests is genuinely in England).

An alternative has been to contractually amend the governing law of the debt to English law (pursuant to the requisite contractual creditor approvals) prior to the scheme in order to create the sufficient connection with England (this was the case for the first schemes of the Belgium, Danish, German and Norwegian companies in the Apcoa Parking group in 2014). In the Apcoa scheme judgment handed down on 19 November 2014, Mr Justice Hildyard explained (paras 253 and 254) that the change of governing law was *"understood and intended to enable such a result…"* (ie to enable the scheme) and that he did not think that the change of law was *"alien or indiscriminate or such as could not reasonably have been contemplated by commercial parties aware of the Rome I-regulation…"*

The English courts have, therefore, on the whole, taken a pragmatic approach in finding a sufficient connection with England. The courts will consider whether the proposed schemes before them would be likely to have a beneficial impact for the business and creditors. This is also reflected in Mr Justice Mann's judgment convening the scheme meetings in the case of Zlomrex: *"An English scheme is preferred over alternatives. A French restructuring would be likely to trigger an event of default with further cross-defaults within the Group which would lead to worse recoveries for creditors than they currently hope to get out of the Scheme… Restructuring in New York is said to be more expensive to the extent of being prohibitive, or almost prohibitive…"*

RECOGNITION OUTSIDE ENGLAND: THE ENGLISH APPROACH

A sufficient connection with England is not the only pre-requisite for schemes of foreign companies. The court will only sanction the scheme if, among other conditions, the scheme will be likely to serve its purpose (ie if the scheme will be recognised in the jurisdiction of incorporation of the company and in any countries where the scheme might need to take effect).

The practice developed in England has been for independent expert foreign law evidence to be produced in court for the English court to satisfy itself that the scheme will be recognised abroad. The New York law expert evidence in Zlomrex was provided by the company's own legal counsel. This has been criticised by the court and the prudent approach would be to use independent experts.

In practice, schemes have, in the large majority of cases, been sanctioned and taken effect without the issue of recognition ever being challenged in the foreign jurisdictions. However, there is one well-known exception: Equitable Life. The Equitable Life scheme was challenged in the German courts. In that case, the German Federal Court did not recognise the scheme based on specific insurance points. However, the German Federal Court made several helpful comments regarding the recognition of schemes in Germany and further schemes of German companies have since been implemented in Germany without any challenges being raised by creditors in Germany. In the recent Apcoa scheme, the English court considered that injuncting creditors from bringing actions in Germany to challenge the scheme was a "step too far" (however, the German law point was settled without the need for an injunction).

RECOGNITION OF SCHEMES IN THE FRENCH COURTS

The two recent French schemes concerned different scenarios: (1) the Zlomrex scheme was a scheme amending US governed high yield notes issued by a French finance vehicle, following a COMI shift of the issuer to the UK; and (2) the Zodiac scheme was a scheme amending English governed bank debt of a French holding company of a group with real trading activity in France. Chapter 15 recognition was obtained in the US for both schemes, on the basis that the companies had a COMI (Zlomrex), or an establishment (Zodiac), in England.

Both schemes benefited from high levels of creditor support. However, the question remains how the French courts would respond should a creditor seek to challenge a scheme of arrangement in a French court.

There are various routes to obtaining recognition of a scheme in the French courts. Firstly, recognition of the sanction order could be obtained, in the limited circumstances described below, using the EC Regulation on Insolvency Proceedings (1346/2000). However, the more likely scenario is that recognition is obtained in the French courts pursuant to the Recast Brussels Regulation (1315/2012).

COUNCIL REGULATION (EC) 1346/2000 ON INSOLVENCY PROCEEDINGS ("INSOLVENCY REGULATION")

Unless a scheme is combined with an insolvency process, the Insolvency Regulation will not assist recognition in the French courts.

Article 1(1) of the Insolvency Regulation restricts the scope of application to "collective insolvency proceedings" and Art 2 defines insolvency proceedings as those listed in Annex A of the Insolvency Regulation. Schemes of arrangement do not figure in the list at Annex A of the Insolvency Regulation (nor any Annex B relating to winding up proceedings) and therefore do not, *per se*, fall within the scope of the Insolvency Regulation. This is because schemes of arrangement are a corporate procedure set out in the English Companies Act, not in the Insolvency Act. Recent proposals for reforms to the Insolvency Regulation have sought to introduce schemes into Annex A but the latest amendments did not make this change and schemes which are outside insolvency proceedings remain definitively outside the Insolvency Regulation.

However, it should be possible to achieve recognition of a scheme in a French court pursuant to Art 25(1) of the Insolvency Regulation if the scheme relates to a company with its COMI in England and which is in an English administration (or another English insolvency process listed in Annex A). Article 25(1) provides that: "*Judgments handed down by a court whose judgment concerning the opening of proceedings is recognised in accordance with Art 16 and which concern the course and closure of insolvency proceedings, and compositions approved by that court shall also be recognised with no further formalities…*" This sub-paragraph also applies to judgments deriving directly from the insolvency proceedings and which are closely linked to them, even if they were handed down by another court.

Therefore, a scheme sanction order could be recognised as a judgment handed down, or composition approved, by a court whose judgment is recognised in accordance with Art 16 of the Insolvency Regulation (ie an administration in accordance with Art 16) provided that the scheme concerns the course of, derives directly from, or is closely linked to, the administration.

Article 16 requires a "judgment opening insolvency proceedings *handed down by a court*". Clearly, the appointment of an administrator in court would be a judgment opening insolvency proceedings handed down by a court. However, Annex A of the Insolvency Regulation also specifically lists administration appointments, which are made without a court order, simply by filing documents at court. Therefore, Art 16 should also include all insolvency proceedings listed in Annex A and one would argue that a scheme could be recognised via Art 25 even if the administrator had been validly appointed without a court order.

There are limited objections to recognition where Art 25 applies. One of the key exceptions is the "public policy exception": pursuant to Art 26, any member state may refuse to recognise insolvency proceedings opened in another member state or to enforce a judgment handed down in the context of such proceedings, where the effects of such recognition or enforcement would be manifestly contrary to that state's public policy, in particular its fundamental principles or the constitutional rights and liberties of the individual.

Subject to any specific factual circumstances, provided the scheme statutory requirements have been duly followed (including due notice being given to creditors), it is difficult to find grounds for a scheme, *per se*, to be contrary to public policy in France. Leading French commentators (see "*L'accueil en France des schemes of arrangement de droit anglais", Etude par Hervé Synvet et Pierre-Nicolas Ferrand, Revue de droit bancaire et financier no. 1, Janvier 2014, étude 1*) have in fact concluded (in the context of Council Regulation (EC) 44/2001, not the Insolvency Regulation), that it seems very unlikely that an English scheme be considered contrary to French public policy, because a French judge himself has the ability to give a debtor certain grace periods for payments and also to revise penalty amounts (Code Civil, Art 1244-1 and 1152).

Given the limited objections available to the French courts and the broad interpretation of Art 25, a scheme of arrangement conducted within an administration should be recognised in France by the French courts pursuant to Art 25 of the Insolvency Regulation.

COUNCIL REGULATION (EC) 1215/2012 ON JURISDICTION AND ENFORCEMENT OF JUDGMENTS IN CIVIL AND COMMERCIAL MATTERS ("RECAST BRUSSELS REGULATION")

The Recast Brussels Regulation came into force on 9 January 2013 and applies to all proceedings on or after 10 January 2015. It replaces and largely follows its predecessor, Council Regulation (EC) 44/2001 ("the Brussels Regulation"), in matters of recognition of judgments and provides for automatic recognition of judgments in many instances.

Where a scheme of arrangement is not combined with an administration, scheme recognition could be obtained in France pursuant to Art 36 of the Recast Brussels Regulation if (i) the scheme falls within the scope of the Recast Brussels Regulation; (ii) the French courts consider that the scheme sanction order is a "judgment" capable of recognition within the meaning of Art 36; and (iii) the French courts do not find grounds to oppose recognition in Art 45.

Scope of Recast Brussels Regulation

The scope of application of the Brussels Regulation was the subject of debate in English, European and French legal commentary in respect of schemes. The scope of the Recast Brussels Regulation remains the same as its predecessor, therefore the judicial interpretation given in respect of the Brussels Regulation continues to remain relevant. Mr Justice Briggs in *Rodenstock* ([2011] EWHC 1104 (Ch)) and Mr Justice Richards in *Magyar Telecom* ([2013] EWHC 3800 (Ch)) both concluded that the sanction of a standalone scheme (outside of an insolvency) did fall within the scope of Art 1(1) ("civil and commercial matters") of the Brussels Regulation.

Mr Justice Richards concluded, in the *Magyar Telecom* scheme judgment, that it logically follows from the exclusion of schemes from Annex A of the Insolvency Regulation that the Brussels Regulation ought to apply and that the exclusion of insolvency proceedings from the scope of the Brussels Regulation does not extend to a scheme of arrangement involving an insolvent company unless that company is also subject to an insolvency proceeding. French commentators have also concluded, in the same vein as Richards J, that the Insolvency Regulation and the Brussels Regulation are intended to dovetail each other and therefore that the bankruptcy exclusion in Art 1(2)(b) should not exclude schemes of arrangements (see para 10, *L'accueil en France des schemes of arrangement de droit anglais, Etude par Hervé Synvet et Pierre-Nicolas Ferrand, Revue de droit bancaire et financier no. 1, Janvier 2014, étude 1*).

"Judgment" within the meaning of the Recast Brussels Regulation

Turning to the second condition for recognition under the Recast Brussels Regulation – is a scheme sanction order a "judgment" within the meaning of the Recast Brussels Regulation?

It could be argued that a sanction order is not a jurisdictional proceeding aimed at specific defendants. However, creditors have often been considered to be the defendants in a scheme as it is the obligations of the company to the creditors which are altered. Furthermore, the definition of judgment in the

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Recast Brussels Regulation (which is the same as in the Brussels Regulation) is very broad: *"any judgment given by a court or tribunal of a member state, whatever the judgment may be called, including a decree, order, decision or writ of execution…"* It would be challenging to argue that the order granted by the court to sanction the scheme was not a "judgment" within the meaning of the Recast Brussels Regulation.

The French courts have traditionally given a wide interpretation to jurisdictional acts, which do not necessarily require a dispute. The German Federal court also held, *obiter* (in the Equitable life scheme), that there were general arguments for recognising an English scheme as a "judgment" under the Brussels Regulation, that Art 32 (which contained the definition of judgment now found in Art 2 of the Recast Brussels Regulation) was to be given a wide interpretation and that the English scheme involved adversarial elements which are a pre-requisite for a "judgment". Therefore, any opposition on this ground would seem likely to fail before the French courts.

Grounds for opposition

Article 45 of the Recast Brussels Regulation also provides specific grounds of opposition to recognition of judgments, which is otherwise automatic under the Recast Brussels Regulation. One of the grounds of opposition which could be raised by creditors is a failure by the English court to comply with the jurisdictional rules regarding insurance, consumer contracts and exclusive jurisdiction when declaring itself competent to sanction the scheme (Art 45(1)(e)). There are also grounds to oppose recognition of a judgment if it is shown that there are prior and conflicting judgments (Arts 45(1)(c) and (d)). Compliance with such rules would need to be assessed on a case-by-case basis.

The French courts could also refuse to allow recognition of the scheme in France using the public policy exception (Art 45(1)(a)) or as a result of a failure to give the scheme creditors sufficient notice of the scheme to allow them to challenge the scheme (Art 45(1)(b)).

As mentioned above, a French court is unlikely to find a scheme, *per se*, manifestly contrary to public policy. A scheme is a consensual process requiring the consent of a super majority of each class of creditors (75% in value and a majority in number of those creditors voting).

It would also be difficult for the French courts to refuse to recognise a scheme on the basis that creditors were not given sufficient notice of the scheme or opportunity to defend themselves. The scheme process includes two court hearings at which creditors can and often do challenge the scheme or propose alternative restructurings. Indeed, the most recent Apcoa scheme hearings lasted a number of days because the scheme was contested by certain creditors. The court considered and heard in detail arguments of such opposing creditors before making its judgment.

Furthermore, it is the practice in schemes to send to all scheme creditors a practice statement letter explaining the details of the scheme and the class formation. This gives the creditors advance notice and time to challenge the scheme at the first court hearing at which the judge is asked to convene creditor meetings to vote on the scheme. In addition a detailed document describing the company and the terms of the scheme, the explanatory statement (akin to a prospectus), is sent out to all creditors ahead of the creditor meetings to vote on the scheme. Creditors are therefore given detailed information before voting on a scheme and have the opportunity to be heard.

Accordingly, the French courts should recognise a scheme pursuant to the Recast Brussels Regulation and it is difficult to find grounds upon which they could refuse to recognise a scheme if a minority creditor sought to challenge the scheme in the French courts.

OTHER GROUNDS FOR RECOGNITION

It should not be necessary to consider other grounds for recognition since ample grounds are provided in the Recast Brussels Regulation.

For completeness, there is no reason why a scheme could not also be recognised in France pursuant to the French rules of international private law. As mentioned earlier, it would be difficult to argue against recognition on grounds of public policy. The French rules of recognition would require a sufficient connection with England (*Simitch, Cour de Cassation* 6 February 1985), which is reminiscent of the concept of "sufficient connection" used by the English courts.

Finally, it is worth noting that Council Regulation (EC) 593/2008 (on the law applicable to contractual obligations) ("the Rome Regulation") has sometimes been considered in the context of recognition of schemes. In *Rodenstock*, the court received expert evidence that the scheme would be recognised in Germany because a German court would apply English law to decide whether the lenders' rights were effectively varied by the scheme. Where the Recast Brussels Regulation applies, it should not be necessary to consider the Rome Regulation because the scheme decision should be recognised without considering the substance of the decision and the law applicable to the decision. Once the English court has rendered its sanction order for the scheme, a French court should not examine the question of conflict of laws and should simply apply the Recast Brussels Regulation in recognising the decision.

CONCLUSION

At the time of writing, the question of recognition of schemes in France remains untested before the French courts. However, this is also the case for the majority of schemes of European companies, which have successfully been implemented in Europe without challenges before the local courts.

The two French schemes (Zodiac and Zlomrex) successfully implemented last year, demonstrate that stakeholders in French restructurings can now consider schemes of arrangement as part of their toolkit for restructurings, alongside the existing safeguard regime. ■

Further reading

- Wish you were here? English court becomes the restructuring destination for foreign companies [2011] 7 JIBFL 405
- English schemes of arrangement: another gateway opened to foreign companies [2014] 4 CRI 154
- LexisNexis RANDI blog: Schemes of arrangements – pushing the boundaries of jurisdiction

Feature

KEY POINTS

- Changes to the Financial Conduct Authority's Mortgage (Conduct of Business) Sourcebook which came into force last year included a new rule requiring each firm to act "honestly, fairly and professionally in accordance with the best interests of its customer".
- Unlike the final text of the Mortgage Credit Directive, the "best interests" obligation is not limited to the provision of advisory services but applies to the entire promoting, advising, selling, servicing and enforcement process.
- Arguably the "best interests" requirement should be met by firms acting honestly, fairly and professionally.

Authors Roger Tym and Elizabeth Greaves

The new MCOB "best interests" rule for residential mortgages: is it fair?

Changes to the Financial Conduct Authority's Mortgage (Conduct of Business) Sourcebook (MCOB), which came into force last year under the Mortgage Market Review (MMR), included a new rule requiring each firm to act "honestly, fairly and professionally in accordance with the best interests of its customer".[1] Does the new rule require mortgage lenders to act in the best interests of customers as well as acting honestly, fairly and professionally or if (as of course they should) they act honestly, fairly and professionally, is that sufficient and in itself in accordance with customers' best interests?

This article looks at this rule in the context of European and UK financial services regulation and its impact. In particular, this article considers whether the rule might go further than the Principle 6 (Treating Customers Fairly (TCF)) requirement to "pay due regard to the interests of its customers and treat them fairly". If so, what does it require? Might it require firms to place the interests of customers above those of the firm?

WHERE DID THE RULE COME FROM?

The FCA has always been concerned that lenders should treat customers fairly. The TCF regime has been in place for a number of years and is central to the FCA's regulatory approach and enforcement toolkit.

At a European level, there has for some time been a requirement to act in customers' best interests in relation to advisory services and services where the firm is essentially acting on behalf of the customer. This has been included in the Markets in Financial Instruments Directive (MiFID)[2] (implemented in the FCA's Conduct of Business Sourcebook (COBS)[3]) and is in the latest draft of the proposed new Insurance Distribution Directive (IDD, formerly referred to as the Insurance Mediation Directive or IMD), in the same form as the "best interests" rule now in MCOB 2.5A.1. This requirement also appeared in the draft Mortgage Credit Directive (MCD). It was, however, removed from the final text and the MCD now requires member states to ensure that, where advisory services are provided to consumers:

> "(d) creditors, credit intermediaries or appointed representatives act in the best interests of the consumer by: (i) informing themselves about the consumer's needs and circumstances; and (ii) recommending suitable credit agreements in accordance with points (a), (b) and (c)..."[4] This is supplemented by a requirement to ensure that: "the remuneration structure of the staff involved does not prejudice their ability to act in the consumer's best interest and in particular is not contingent on sales targets".[5]

The MCD requirement also states how firms are expected to act in customers' best interests, by complying with the specified informing and recommending obligations.

On reflection, this is understandable. There is an important difference between:

- a "client" relationship where a firm is acting in an advisory capacity and providing ancillary services and must have interests that, in relation to provision of the core service, are aligned with the customer's interests; and
- lending products, where the central part of the relationship is a customer buying a product from a seller.

When providing advice, a firm should be aiming to achieve the best outcome for its client and must be prevented from compromising the customer's wellbeing by any conflicts of interests. Here, it is easy to see the rationale for acting in the client's "best interests".

When selling products to customers, a firm's proper commercial aim is to make profit from the product itself, rather than from separate advisory services. In the context of mortgages, the firm's profit is generated from the lending of money (principally in the form of interest), rather than providing advisory and ancillary services.

The new MCOB "best interests" rule was settled before the final draft of the MCD was published. Rather than limiting the obligation to the provision of advice, the MCOB wording applies to the entire promoting, advising, selling, servicing and enforcement process. Whilst the "best interests" rule has an important role for mortgage advisory services, the rationale for an overarching best interests requirement is much weaker and arguably not applicable at all in the context of the core lending, where the relationship is quite different and customers are already shielded by a plethora of consumer-protection regulations including TCF.

The FCA was given responsibility for consumer lending from April 2014, around the same time as MMR and the new best interest rule were implemented for residential mortgages. The FCA's Consumer Credit Sourcebook (CONC) requires that "all advice given and action taken by the firm... has regard to the best interests of the customer."[6] Although "advice given" should have regard to the best interests of the customer, it is not clear what is included within "action taken". The rule is not identical to the MCOB best interests rule but it does seem that the "best interests" concept has been creeping beyond the limits of advice and spilling into the general selling

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and servicing process of products where the interests of seller and buyer cannot be aligned and are already heavily regulated.

This is only a problem if these rules go further than TCF. Firms already have to balance their own interests against those of their customers and treat them fairly by achieving the six TCF outcomes.[7] If the "best interests" rule is simply another incarnation of TCF, perhaps with a more European slant, that is fine. If it imposes a whole new standard, what is that standard and what might it require of lenders?

"BEST INTERESTS" V "TCF"

There has long been an ongoing tension between principles-based and rules-based regulation. If a firm follows specific rules designed to deal with a particular situation, is that enough or could TCF require further or different action? The status of TCF was confirmed in the 2011 Judicial Review in the context of PPI misselling.[8] The court held that firms had failed to comply with TCF, despite the fact that all specific rules were adhered to. The court explained that TCF was a separate and overarching principle, rather than the result of compliance with all other FCA rules and guidance.

As an overarching rule, could the "best interests" rule be applied in a similar manner to TCF? Even if a firm complies with all relevant specific MCOB provisions and with TCF requirements, could the FCA still find that it did not act in the best interests of the borrower? If so, firms could never be confident that they are fully compliant and regulatory action is a constant and unavoidable threat, even where all specific rules are followed and the firm achieves all required TCF outcomes.

TCF effectively requires balancing the interests of the customer and those of the firm. If a firm must act in accordance with the "best interests" of customers, does this require firms to place the interests of customers above their own commercial interests, rather than achieving a fair balance? Taken to its logical conclusion, this would require firms to disregard any question of profit or growth and instead focus on the outcome which would most benefit the customer. Absurdly, this could result in firms becoming insolvent or ceasing to make any profit at all. The case studies shown above illustrate what this could mean for mortgage lenders.

This cannot be the intention of the FCA. It is in the interests of customers generally for financial institutions to be able to offer high quality services and products. It is therefore evident that the FCA must have an alternative standard in mind, which allows firms to run a sustainable business whilst treating customers fairly and taking their interests into account.

For this to apply, the MCOB rule, to act "honestly, fairly and professionally in accordance with the best interests of its customer" should be viewed as operating in a similar way to the MCD rule: so that customers' best interests are achieved by complying with specified obligations, in this case, by acting honestly, fairly and professionally. By acting in that way, mortgage lenders will be acting in accordance with the best interests of their customers.

It would be helpful for the FCA to provide guidance to clarify the scope of the new rule and ensure that all firms are equipped to be fully compliant. ■

CASE STUDIES

Depending on a firm's interpretation of the obligation (and taken to the extreme), acting in a customer's "best interests" could have strangely divergent impacts on different firms.

Firm A

Imagine a firm (Firm A) which takes a literal view of its "best interests" obligation. If a customer (Customer A) asks for a mortgage, Firm A must consider whether he should be borrowing at all. Perhaps it is better for Customer A to rent a property, or continue to live with his parents? Customer A asks for a mortgage of £500,000 for a four bedroom house. Firm A suggests that Customer A purchases a smaller house and saves money for the future. Although Customer A asks for an execution-only loan, Firm A insists on providing full advice. Firm A charges no interest on the loan.

When Customer A defaults on his mortgage, Firm A has the right in its mortgage documentation to charge fees, take possession and ultimately sell the property. However, this would clearly be detrimental to Customer A, and Firm A avoids doing so. As Firm A has offered interest-free credit and refuses to enforce its security, it must enter insolvency proceedings.

Firm B

Firm B has a more balanced approach. Although Customer B asks for an expensive mortgage on a large house, Firm B undertakes an affordability assessment and sees that Customer B can afford the loan, with plenty of income to spare. As Customer B seems eager to live in a large house and is an intelligent adult capable of making such decisions, Firm B agrees to lend £500,000.

When Customer B asks for an execution-only transaction, Firm B warns him that some protections under MCOB will not apply and reiterates the benefits of receiving mortgage advice. Customer B insists on execution-only, and Firm B proceeds. Firm B charges interest at the market rate and acts with forbearance when Customer B defaults, balancing its own interests with that of Customer B. Throughout the relationship, Firm B acts honestly, fairly and professionally, taking Customer B's interests into account where appropriate.

1 MCOB 2.5A.1.
2 Directive 2004/39/EC, Art 19(1).
3 COBS 2.1.1.
4 Directive 2014/17/EU, Art 22(3)(d).
5 Directive 2014/17/EU, Art 7(4).
6 CONC 8.3.2R.
7 PRIN 2.1 and http://www.fca.org.uk/firms/being-regulated/meeting-your-obligations/fair-treatment-of-customers.
8 *British Bankers Association v Financial Services Authority and Financial Ombudsman Service* [2011] EWHC 999.

Further reading

- Out with "TCF" and in with "fiduciary"? [2012] 6 JIBFL 343
- LexisNexis Loan Ranger blog: can new rights for sellers bind mortgage companies?

Feature

KEY POINTS

- Full implementation leaves uncertainties which are unlikely to be resolved until the failure of a major bank.
- A particular problem is whether a court outside the EU would recognise a bail-in ordered by a resolution authority in another EU member state.
- The interaction between "market contracts" and bail-in powers (where, for instance, a bank acting as a clearing member is subjected to bail-in) remains unclear.

Author Peter King

The EU Bank Recovery and Resolution Directive: moving towards full implementation

The European Union's Directive dealing with planning for the recovery and resolution of failing banks took many years to reach political agreement. Member states should have implemented it in full by now. However, even in countries such as the UK which already have many of the key powers and regulatory controls in their law, implementation leaves uncertainties which are unlikely to be resolved until the failure of a major bank.

This article considers how implementation has been handled with particular reference to the UK, and notes some remaining legal uncertainties.

The question of how to avoid another financial crisis continues to occupy banking regulators around the world. It is in the nature of banks to take risks, and better management of those risks has become a pre-occupation of boards of directors of banks. But even the best managed banks can be subject to financial stresses that lead to potential failure and insolvency. Finding legal and regulatory tools to manage failure, either with a view to recovery or to continuation of parts of the failed business, has emerged as one of the keys to dealing with future crises.

In November 2013, when this journal last covered this subject ([2013] 10 JIBFL 641), we were still awaiting the final adopted text of the EU Recovery and Resolution Directive. During 2014 the legislative process moved on rapidly, and the Directive has been adopted with a target implementation date of 1 January 2015 for all member states.

IMPLEMENTATION PROGRESS IN THE UNITED KINGDOM

The importance of the financial services industry to the UK economy and the political attention it has received has led to the UK Government adopting an unusual approach to implementing the Directive. Usually it would wait for the finalisation of a directive and then introduce appropriate legislation to implement it, but in this case it has introduced much of the implementing legislation before the Directive was finalised.

The Directive provides for resolution authorities to have a wide range of tools and intervention mechanisms to deal with a failing bank, including early intervention powers, powers of sale over the whole bank, powers to set up a bridge bank or to separate assets and liabilities of the bank and power to "bail in" certain liabilities. Many of these powers already exist under English law. The Banking Act 2009 established a special resolution regime for banks and certain other participants in financial markets. Among other things, this includes the power for the Bank of England to arrange for the transfer of all or part of a failing bank's business to a private purchaser, or to a publicly controlled bridge bank, or to take all or part of the failing bank's business into temporary public ownership.

The Banking Act 2009 was further amended by the Financial Services (Banking Reform) Act 2013, principally to introduce a bail-in option to the tools available to the Bank of England as resolution authority. When this legislation was passed the Directive had not yet been finalised, but the UK Government believed that the bail-in powers mandated by the Directive would not be significantly different from those conferred by the UK legislation.

After finalisation of the Directive it was necessary to make further amendments to the law in the UK to reflect its final form, and this was done by four statutory instruments made under the powers conferred by the European Communities Act 1972, all of which came into force on 1 January 2015. The amendments to the existing legislation are extensive, particularly in areas such as the resolution tools and the bail-in powers. The result is that analysing the transposition of the Directive into English law requires consideration of complex amendments and re-amendments of primary legislation.

Some aspects of the Directive have been supplemented by additional rules made by the Prudential Regulation Authority (PRA). The PRA rules deal with issues such as the contents of recovery plans, the information to be provided to the PRA in the context of resolution planning, and impose certain requirements on banks in relation to bail-in and other powers.

IMPLEMENTATION AT THE EUROPEAN LEVEL

The Directive confers certain powers on the European Banking Authority (EBA), whose influence on national regulators and on the banks they regulate is increasingly felt. In the context of the Directive, the EBA's main role is to create technical standards. The technical standards contain useful guidance about how the Directive's requirements are to be implemented in practice. For example, the draft technical standard on bail-in requires

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national regulators to ensure that contractual obligations governed by the law of a country outside the EU contain a contractual provision binding the counterparty to accept the results of a bail-in (see further below).

Another technical standard relates to how shares are treated in a bail-in, and requires them to be diluted or cancelled depending on the valuation made in accordance with Art 36 of the Directive. If this shows a nil or negative net asset value, existing shares are to be cancelled or written off: if there is a positive net asset value shares will be diluted or written down. A third technical standard relates to the rate of conversion of debt to equity in a bail-in.

There is also an EBA standard on how colleges of regulators will be operated in cross-border resolution cases, and one on procedures for resolution planning. The day-to-day work of national regulators, as well as their conduct when a resolution is required, is likely to be increasingly driven by these standards made at the EBA level. Interpreting them in the context of a fast-moving situation where a bank is in financial difficulties is likely to prove a considerable challenge, and to require real-time interaction between the EBA and the national regulators involved.

CROSS-BORDER ISSUES

As with any piece of European legislation, issues can arise when the legislation is implemented and applied in all member states. The examples from the UK above illustrate how complex the implementation process can be. In the case of this Directive, which is meant to apply to banks with businesses across the whole of the European Union, the different approaches to implementation in different member states are almost bound to lead to conflicts when the legislation is tested. A key question will be whether the arrangements for resolution colleges of regulators will be robust enough to deal with these conflicts.

A particular problem arises in relation to the bail-in powers conferred on resolution authorities. Capital instruments issued into international capital markets are likely to be governed by English or New York law, while the bank issuer may be incorporated under the law of another member state. Any insolvency would most probably be handled under the law of the state of incorporation. A question then arises about whether a court adjudicating on the liabilities under the capital instruments, presumably in London or New York, would recognise a bail-in ordered by a resolution authority in another EU member state. Outside the realm of typical internationally-traded bonds and other capital instruments, it is possible to envisage even more complex problems of conflict of laws.

The UK's PRA has tried to deal with this by requiring all capital instruments to include a contractual provision in relation to bail-in powers. This will assist both in UK courts and in other courts around the world where such a contractual provision is seen as effective. It will not fully obviate the potential issue: it is possible to envisage a court somewhere in the world where such a provision might be held unenforceable, perhaps on the grounds that it unfairly deprives the holder of a right against a UK bank of his property. The problem is likely to be more acute where the conflict arises with the law of a country outside the European Union, because most countries within the European Union will be following the EBA's technical standards and their courts will be pre-disposed to give effect to an EU directive. This is the sort of problem which European legislation alone cannot solve. The Financial Stability Board has recognised this in its recent paper on cross-border recognition of resolution action.

OTHER UNCERTAINTIES

Banks are complex institutions which handle the transference of risk. It is not surprising that a regime which gives a regulator unprecedented powers, including powers to alter the normal priorities of creditors, creates legal uncertainties which will need to be resolved in the courts whenever these new powers are tested. There are many examples of this in the UK context. In its paper responding to the consultation on the UK implementation of the Directive, the Financial Markets Law Committee of the Bank of England drew attention to several examples, two of which are as follows:

- Although it is clear that bail-in powers do not apply to basic remuneration payable to employees, they do apply to bonuses or variable remuneration. The treatment of debts to pension schemes, which has given rise to complex litigation following the Lehman collapse, is not clarified by these provisions.
- Settlement of many financial contracts depends on the use of settlement systems which operate through a central counterparty and rely on security over assets given to the market. The interaction between these "market contracts" and the bail-in powers (where for instance, a bank acting as a clearing member is subject to bail-in) remains unclear.

CONCLUSION

As the 2008 financial crisis showed, financial problems within a bank can arise very quickly. Solutions which deal with immediate problems are often followed by a lengthy period of unwinding of residual liabilities and, more often than not, litigation. Litigation arising from what happened in 2008 (including actions by regulators and governments at that time) is still continuing.

The powers conferred by the Directive are now being implemented across Europe. They may well make it easier for central banks and other regulators to deal with another crisis, in that they will provide additional and powerful tools which the regulators can use. The efficacy of these tools will only really be tested when there is another crisis. In the meantime there will continue to be many aspects of the new regime where the outcome in a crisis cannot be predicted with certainty. ■

Further reading

- The EU Resolution and Recovery Directive: preventing another financial crisis [2013] 10 JIBFL 641
- Contractual recognition of resolution actions [2015] 3 JIBFL 188A
- LexisNexis RANDI blog: Three-step strategy for resolution of failed institutions

Feature

KEY POINTS

- Malta is the first European Union member state to legislate for cell companies in a securitisation context, building on the jurisdiction's experience in cell structures and robust legislative framework for securitisation transactions.
- Securitisation cell companies (SCCs) can be used for the establishment of platform structures for any form of securitisation transaction, offering quicker set-up time and lower transaction costs.
- The possibility of multi-currency vehicles opens up new structuring possibilities.

Authors Nicholas Curmi and Matthew Mizzi

The Maltese Securitisation Cell Companies Regulations: an overview

The recently introduced Securitisation Cell Companies Regulations (SCC Regulations)[1] provide the legal framework for the establishment of Maltese securitisation cell companies (SCCs), structures that can create segregated cells for all manner of securitisation transactions, including insurance-linked securitisation. This article analyses the salient features of the new SCC Regulations and its headline innovations.

LEGAL BASIS

Article 84C of the Companies Act[2] enables the legislator to "make regulations which provide for the formation, constitution, authorisation and regulation of cell companies, and which make it possible for a securitisation vehicle to convert into a cell company and for all matter that may arise in connection therewith". The SCC Regulations were enacted on 28 November 2014 following a period of consultation.

MALTA'S LEGAL EXPERIENCE IN CELL STRUCTURES

The SCC Regulations continue to build on Malta's experience in legislating for cell entities in various sectors including insurance (protected cell companies or PCCs), funds (umbrella or multi-fund structures), private client and the not-for-profit sectors (foundations and other legal organisations). The SCC Regulations draw on the successful features of Malta's various pieces of cell legislation in these sectors and also introduce some important innovations that will provide securitisation structures with the flexibility and utility of cell entities.

SECURITISATION PURPOSES

Regulation 4 of the SCC Regulations provides that an SCC may be established solely for the purpose of either entering into securitisation transactions *or* the assumption of risks as a reinsurance special purpose vehicle.

The term "securitisation" is defined in Art 2 of the Securitisation Act[3] as a:

> "transaction or an arrangement whereby a securitisation vehicle, directly or indirectly: (a) acquires securitisation assets from an originator by any means, or (b) assumes any risks from an originator by any means, or (c) grants secured loan or other secured facility or facilities to an originator and finances any or all of the above, directly or indirectly, in whole or in part through the issue of financial instruments, and includes any preparatory acts carried out in connection with the above".

> "Regulation 4 of the SCC Regulations provides that an SCC may be established solely for the purpose of either entering into securitisation transactions *or* the assumption of risks as a reinsurance special purpose vehicle"

Although the Securitisation Act caters for securitisation transactions involving the assumption of risks, vehicles established for the specific purpose of issuing insurance-linked securities are also subject to the Reinsurance Special Purpose Vehicles Regulations (RSPV Regulations)[4] which transpose the provisions of the Solvency II Directive (and its implementing measures) regulating the authorisation of such issuers. The RSPV Regulations define a reinsurance special purpose vehicle as:

> "an undertaking, other than an existing insurance undertaking or reinsurance undertaking, which assumes risks from a ceding undertaking and which fully funds its exposure to such risks through the proceeds of a debt issuance or any other financing mechanism where the repayment right of the providers of such debt or financing mechanism are subordinated to the reinsurance obligations of such a vehicle".

ESTABLISHMENT OF AN SCC

No prior regulatory or administrative approval is required for the establishment of an SCC, unless the SCC is established as a reinsurance special purpose vehicle or a public securitisation vehicle that issues securities to the public on a continuous basis, in which case the SCC would require authorisation pursuant to the RSPV Regulations or the Securitisation Act, respectively.

The memorandum and articles of association of the SCC must state that the company is an SCC. In addition, the name shall include the designation "Securitisation Cell Company" or "SCC".

The minimum share capital required for the establishment of an SCC (established as a private limited company) is €1,165, of which at least 20% must be paid up. Shares in the SCC are to be subscribed by a minimum of two shareholders and its affairs administered by at least two directors.

An SCC can be established as a private limited company with a single director, two shareholders (one of whom can hold a single non-voting and non-participating share), and a minimum authorised and issued share capital of €1,165 (at least 20% of which must be paid up). However, if the SCC intends to list its securities and/or offer those securities to the public, then it must be established as a public limited company with two directors, two shareholders (one of whom can hold a single non-voting and non-participating share), and a minimum authorised and issued share capital of €46,588 (at least 25% of which must be paid up). Share capital can be applied towards the initial and ongoing expenses of the vehicle, whether it is a private or public company.

It is expected that the Companies Act will shortly be amended to allow private limited companies to list their securities provided that they are not also offered to the public.

SINGLE LEGAL ENTITY; MULTIPLE PATRIMONIES

While a cell company may create one or more cells, reg (4) of the SCC Regulations provides that cells do not have a separate legal personality and that the SCC will be treated as a single legal person.

Nevertheless, reg 4(4) provides that the assets and liabilities attributable to each cell will be treated as a segregated patrimony distinct from the assets and liabilities attributable to other cells and separate from the assets and liabilities attributable to the SCC generally (ie the non-cellular or "core" patrimony).

SEGREGATION OF PATRIMONIES; NO CROSS-CONTAMINATION

The SCC Regulations contain various provisions designed to ensure the segregation of assets and liabilities between the different cells and to ensure that no cross-contamination (consolidation) occurs in the event of insolvency of a cell.

Cellular assets attributable to a cell of an SCC are only available to the creditors of the vehicle in respect of that cell and are not available to meet liabilities attributable to other cells.

Conversely, reg 12 of the SCC Regulations provides that a liability attributable to a cell may only be met using assets attributable to that particular cell. Regulation 12(2) will allow a vehicle's promoters to make provision in the company's constitutive documents to apportion certain costs relating to the day-to-day administration of the vehicle to the various cells.

> "… reg 4(4) provides that the assets and liabilities attributable to each cell will be treated as a segregated patrimony distinct from the assets and liabilities attributable to other cells and separate from the assets and liabilities attributable to the SCC generally"

Regulation 10(1) of the SCC Regulations provides that it shall be an implied term in every transaction with an SCC that no party to that transaction may seek to satisfy any liability not attributable to the cell by seeking to recover by any means against assets attributable to other cells. In the event that a creditor succeeds in recovering a sum in contravention of this Regulation, the creditor would be required to refund the cell from which the assets were wrongly obtained.

The SCC Regulations also importantly provide that any proceeding taken against an SCC shall respect the status of each cell as a segregated patrimony separate from the assets and liabilities of other cells and from the non-cellular patrimony of the SCC. Moreover, any administrator or liquidator appointed in respect of an SCC is required to respect segregation between cells.

Regulation 7(2) of the SCC Regulations requires directors of an SCC to keep assets attributable to the different cell separately identifiable from the assets attributable to other cells and from the assets not attributable to any cell, including a specific requirement to hold separate records, accounts and statements.

ESTABLISHMENT OF CELLS

A cell may be established by means of a resolution of the board of directors of the company resolving to establish a cell for the purpose of entering into a securitisation transaction. Each cell shall have its own distinct name or designation, which shall include the word "cell".

Although it is not required to constitute a cell, an SCC may issue shares, referred to as "cell shares", in respect of cells it establishes and the proceeds of the issue of cell shares would form part of the patrimony of the cell in respect of which the shares were issued. Shares may also be issued by the vehicle in respect of its non-cellular patrimony, in which case the proceeds would be considered as non-cellular assets. Unlike protected cell companies or multi-fund structures, therefore, the establishment of a cell need not be linked to the issuance of cell shares or a separate class of shares – a board resolution in the required terms will suffice.

An SCC is required to deliver a copy of the resolution establishing the cell to the Registrar of Companies in Malta within 14 days of its date.

In addition, an SCC is also required to notify the Malta Financial Services Authority (MFSA), in its capacity as competent authority under the Securitisation Act, that it intends to enter into one or more securitisation transactions in respect of a cell prior to the commencement of business of that cell.

An SCC can enter into one or more

Feature

Biog box

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securitisation transactions in respect of a single cell, provided that there can only be one originator of securitisation assets for each cell. This is the case irrespective of the purpose for which the SCC was established, ie whether for insurance-linked securitisations or other forms of securitisation transactions generally. In either context, entities that form part of the same group will be considered as a single originator.

REINSURANCE SPECIAL PURPOSE VEHICLES

One of the main attractions of SCCs is their potential for use as platform structures for insurance-linked securities transactions such as collateralised reinsurance, private catastrophe bonds and bespoke longevity solutions.

An SCC may be established as a reinsurance special purpose vehicle only after prior authorisation by the MFSA is obtained. The authorisation process for the establishment of an SCC for the purpose of issuing insurance linked securities incorporates the criteria set out in the RSPV and the Solvency II regime for securitisation vehicles.

Each cell of an SCC authorised as a reinsurance special purpose vehicle is also subject to prior regulatory approval by the MFSA.

As indicated above, each cell established by an authorised SCC (authorised as a reinsurance special purpose vehicle) may enter into one or more insurance-linked securitisation transactions provided that the insurance risks assumed always originate from the same insurance undertaking or an insurance undertaking belonging to the same group. However, different cells may enter into transactions with different originators thus enabling SCCs to be used as platform structures.

The fully funded capital requirement that applies to securitisation special purpose vehicles established under the RSPV Regulations (and therefore in accordance with Solvency II) will apply on a cell-by-cell basis.

PUBLIC SECURITISATION VEHICLES

A securitisation vehicle that issues or intends to issue financial instruments to the public on a continuous basis will be considered as a public securitisation vehicle under the Securitisation Act, and will accordingly require a license from the MFSA prior to issuing financial instruments to the public.

ISSUE OF FINANCIAL INSTRUMENTS

Maltese SCCs may, in respect of any of its cells, issue one or more financial instruments in one or more tranches, the proceeds of which would form part of the cellular assets of the cell in respect of which the financial instruments are being issued.

MULTI-CURRENCY VEHICLES

The SCC Regulations empower the directors of the company to choose a different base currency of each cell of an SCC, and the base currency of each cell may be different from the currency of the non-cellular share capital of the SCC. Where the directors do not specify the base currency of a cell, it will be deemed to be the currency of the non-cellular share capital of the SCC. While a cell can have only one base currency, financial instruments issued in respect of that cell may be denominated in multiple currencies.

Annual accounts of the SCC can be drawn up in the currency of the non-cellular share capital or the base currency chosen in respect of any of the cells. Directors of an SCC are also required to maintain accounting records in respect of each cell in the base currency chosen in respect of that cell.

APPLICATION OF THE SECURITISATION ACT

SCCs are also subject to the provisions of the Securitisation Act. The Securitisation Act provides several statutory solutions that were specifically designed to provide greater certainty in respect of the typical structuring concerns of investors and credit rating agencies, including true sale, bankruptcy remoteness, non-petition clauses, priority of creditors and limited recourse provisions.

Moreover, SCCs are specifically exempt from any kind of licence (except that required for public securitisation vehicles or reinsurance special purpose vehicles, of course). In this regard, the Securitisation Act also specifically provides that a securitisation vehicle will not be considered to be a collective investment scheme (and, correspondingly, not an alternative investment fund) under Maltese law,[5] which is particularly relevant to securitisation transactions that involve a dynamic portfolio of underlying assets.

CONTINUING MALTA'S TRADITION

The SCC Regulations continue Malta's tradition in legislating for cell structures by extending the concept to the securitisation context, providing a statutory confirmation that each cell constitutes a separate patrimony and that the segregation of assets between cells will be respected, both in the event of insolvency or otherwise. When considered with the innovative provisions of the Securitisation Act, and, in the case of reinsurance special purpose vehicles, those of the RSPV Regulations, the SCC Regulations broaden the structuring opportunities available for arrangers of securitisation transactions. ■

1 Subsidiary Legislation 386.16, Laws of Malta.
2 Chapter 386 of the Laws of Malta.
3 Chapter 484 of the Laws of Malta.
4 Subsidiary Legislation 403.19, Laws of Malta.
5 See GANADO, Ambery, Mizzi, 'Maltese Securitisation Vehicles are not Alternative Investment Funds', [2014] 7 JIBFL 465.

Further reading

- Segregated portfolio companies: underused and misunderstood? [2014] 1 CRI 26
- Maltese Securitisation Vehicles are not Alternative Investment Funds [2014] 7 JIBFL 465
- Lexis PSL Banking & Finance: Malta – cross border banking and finance guide

KEY POINTS
- It is the first project bond in Italy, ie the first case where an Italian asset company has issued a bond which is structured and secured as per a project finance loan.
- The deal is hybrid (ie a combination of bank and bond tranches which are *pari passu*) and is also a holdco financing, a portfolio financing and a refinancing of existing debt.
- The structure has been applied to a portfolio of solar assets but can be applied to any other infrastructure assets (wind farms, hospitals, toll roads, undergrounds, gas distribution, LNG regasification terminals, gas storage, airports, etc).
- The bond is unwrapped, unrated and fully secured: all innovative features in the Italian infrastructure debt market.
- The €85m bond has a tenor of 14 years, is fully amortising and has a fixed rate tranche priced at 3.5% and a floating rate tranche priced at Euribor + 3.3% (+ the hedging cost).

Authors Carloandrea Meacci, Francesca Brilli and Nicola Toscano

Project Brainwave: the first project bond in Italy

Project Brainwave showcases a new and attractive model for raising long term infrastructure debt with competitive pricing and without a complex rating process. Thanks to the Italian Government's new regulatory and tax framework, non-bank lenders are now able to finance infrastructure assets through project bonds, ending the monopoly banks had over lending to Italian companies.

PROJECT BRAINWAVE: BACKGROUND

Project Brainwave[1] is a €175m hybrid (bank and bond) refinancing of the existing debt of Antin Solar Investments SpA ("Holdco"). Holdco controls seven project companies owning nine ground mounted operational photovoltaic plants with a total installed capacity of 77.2 MW. These plants are located in three regions of Italy and had originally been financed through project finance facilities and leasing facilities.

Holdco's debt was refinanced through:

(a) three bank facilities (€90m), ie a term loan facility for refinancing existing debt and the payment of transaction costs, a VAT facility for refinancing VAT paid during the construction of the photovoltaic plants and a liquidity facility to finance any debt service shortfall prior to the final maturity date (in lieu of a cash debt service reserve account); and

(b) two tranches of bonds (€85m, including a fixed rate tranche and a floating rate tranche) subscribed by infrastructure debt funds Aviva and Scor.

The proceeds of the term loan facility and of the bonds have been on-lent by Holdco to its subsidiaries (other than Matos Srl) to repay in full their existing debts, as shown in Figure 1 below.

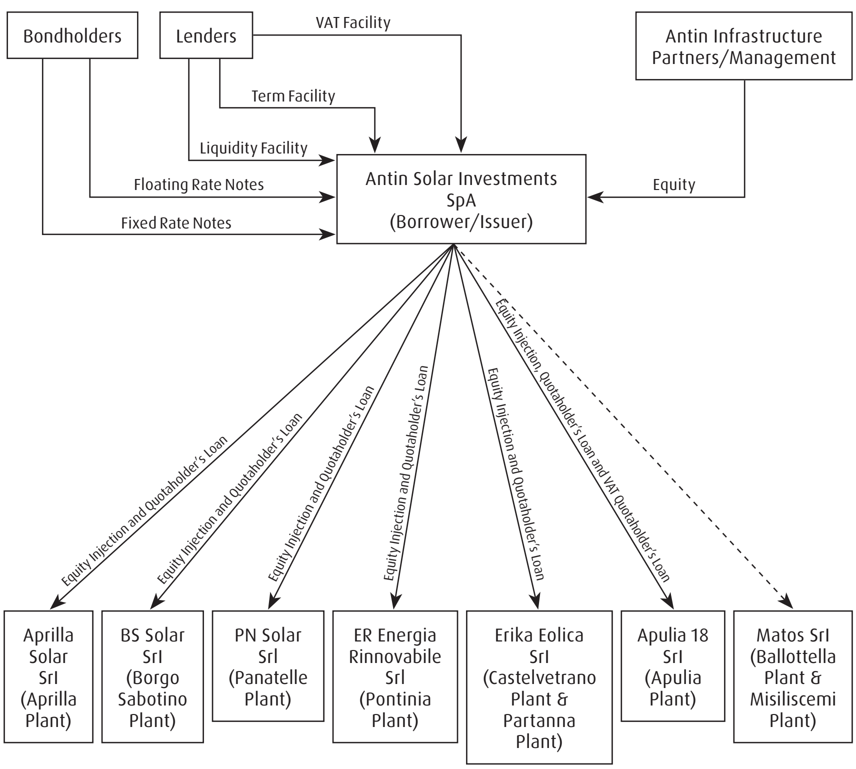
The deal is structured in a way that can be easily replicated in other sectors and with other clients. This is because the bonds are unrated and also unwrapped, ie they do not rely on any credit enhancement by third parties.

The deal has also been structured so that it benefits from recent regulatory and tax changes such as:

(a) the lifting in certain cases of the 26% withholding tax previously applicable to interest payments on the bonds;

(b) the application of an umbrella registration tax equal to only 0.25% on the security package;

FIGURE 1: STRUCTURE



(c) the lifting of the strict limits on the size of the bond;
(d) the introduction of a concept similar to the English law security trustee, allowing bond transfer without the need to enter into deeds of amendment of the security package;
(e) certain bondholders may now benefit from the special privilege over moveable assets (similar to an English law floating charge), which was previously applicable only to certain bank loans.

All of which now make bond financing of long term infrastructure assets competitive as compared to bank financing.

THE CONTRACTUAL STRUCTURE

All the finance documents except the hedging agreements are governed by Italian law.

Documents common to bank and bond debt

Common terms agreement

The key document is the common terms agreement setting out representations and warranties, covenants, events of default, mandatory prepayment events and conditions precedent applicable to all classes of financiers (bank and non-bank lenders).

> "A challenge faced by the deal was that the extensive controls usually required by project finance lenders had to be reconciled with the less restrictive approach usually accepted by bondholders"

Mandatory prepayments

Mandatory prepayment events and prepayment fees are areas where the traditional project finance world and the traditional capital markets world clash because such prepayment events are typical in project finance but unusual in capital markets. In contrast, prepayment fees are standard in capital markets but unusual in project finance. The compromise reached on this transaction has been that a project-finance type list of mandatory prepayment events applies and both the lenders and the bondholders have the right to be prepaid on such events. However, there is a mechanism whereby bondholders may refuse the relevant prepayment. Prepayment fees apply to the bond only in case of voluntary prepayment and non-permitted change of control.

Covenant lite

Another challenge faced by the deal was that the extensive controls usually required by project finance lenders had to be reconciled with the less restrictive approach usually accepted by bondholders. This was particularly important in the context of a refinancing at the Holdco level (as opposed to asset level), where banks had to address the concern of the sponsor who was keen to be able to expand the portfolio. The compromise reached after extensive negotiations is a covenant package which is lighter than is typical in project finance and stronger than is typical in capital markets.

Flexibility in the debt structure

The common terms agreement structure facilitates multiple classes of debt and can be used as a platform where the borrower may raise additional debt. For example the facility which may be granted by Cassa Depositi e Prestiti SpA, a state-owned entity, in relation to certain cuts to the incentives for solar plants, provided that certain conditions are satisfied.

Conditions precedent and drawdown of the debt

The common terms agreement also contains the conditions precedent to the first drawdown of the debt. On the closing date, the proceeds of the refinancing facilities and the bond tranches were simultaneously advanced to Holdco. At the same time they have been on-lent by Holdco to the asset companies towards repayment of their existing lenders and release of their security. This complex arrangement under Italian law allowed the asset companies simultaneously to grant first ranking security to the new financiers.

Intercreditor agreement

The intercreditor agreement deals with the relationships between the various classes of creditors such as the bondholders, the lenders, the hedging banks and the transaction agent. A number of adjustments were made to the usual project finance intercreditor agreement in order to take into account the complexity of different classes of creditors including the following:

- the intercreditor agent may decide in its own discretion certain minor matters;
- lower quorum and majorities were provided for the ordinary voting matters and the extraordinary voting matters;
- unanimous decisions of all the voting creditors were avoided to prevent a deadlock. However, in order to preserve a degree of control by each class of creditors, the type of decisions which are usually taken by unanimous lenders in a typical project finance loan were translated into entrenched rights. This means that in case a waiver triggers the entrenched rights of one of more classes of creditors, such waiver cannot be approved or denied without the approval or denial of the affected creditor(s). To take such a decision, the affected creditor(s) will use the voting procedure provided under the relevant finance document, ie the loan agreement for the banks and the bond terms and conditions for the bondholders. This means that:
  - if the affected creditor is a lender, the decision will be in most cases

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taken by unanimous lenders;
- if the affected creditor is a bondholder, the decision – under Italian law – shall be approved by the bondholders meeting with a supermajority.

Other finance documents

As noted above, some finance documents are entered into only by certain classes of creditors as follows:

Bond documents

Notes subscription agreement

- The notes subscription agreement details the obligations of the issuer and of the bond subscribers in relation to the bonds, eg the subscription price, the settlement of the bonds and the selling restrictions.

Terms and conditions of the bonds

- The terms and conditions of the bonds (attached to the notes subscription agreement) set out the main economic terms such as the principal amount of the bond, the interest rate, the repayment profile, the interest payment schedule and the rules applicable to the bondholders' meetings.

Agency agreement

- The agency agreement details the terms upon which the principal paying agent, the local paying agent and the calculation agent are appointed and shall provide certain calculation, paying and agency services in relation to the bond.

Bank documents

The facilities agreement sets out the bank facilities including their principal amount, the interest rate and the rules applicable to the lenders' decisions.

Hedging agreement

This agreement has been entered into by the Holdco with the hedging bank to cover the interest rate risk for the floating rate notes and for the term facility under the facilities agreement.

Security package

In light of the tax and regulatory changes described above, the structure includes a project-finance type security package (at the level of both Holdco and Holdco's subsidiaries) granted in favour of both the lenders and the bondholders, both only subject to a 0.25% registration tax.

> "Project Brainwave showcases an appealing structure for raising long term infrastructure debt with competitive pricing and without a complex rating process"

The bondholders exercise their rights under the security documents through a security agent, which allows for a straightforward transfer of the bonds in the secondary market.

Listing of the bond

The bond has been admitted to negotiation on the Extra-MOT PRO, a multilateral trading facility of the Italian stock exchange reserved for professional investors.

The admission to negotiation on a multilateral trading facility was driven by legal considerations as opposed to ease of trading. In particular, if the bond is not listed nor admitted to negotiation on a multilateral trading facility, certain legal issues arise as to, for example, the liability of the (initial) subscriber of the bond in case of bankruptcy of the issuer and as to whether the (initial) bondholders are subject to prudential supervision (*vigilanza prudenziale*). The admission to negotiation on the Extra-MOT PRO is relatively straightforward, inexpensive and timely as, for example, the ordinary prospectus can be replaced by a simpler admission document.

CONCLUSION

In summary, Project Brainwave showcases an appealing structure for raising long term infrastructure debt with competitive pricing and without a complex rating process.

In this case the structure was a hybrid of bank and bondholder debt. However, we are also seeing cases in the market where only the bond tranche is contemplated.

This structure was created for a portfolio of solar assets but is expected to be used for the financing of other infrastructure such as wind farms, hospitals, toll roads, undergrounds, gas distribution, LNG regasification terminals, gas storage, airports, etc.

One fascinating challenge is verifying the extent to which financiers will feel sufficiently comfortable in using such a structure for greenfield projects and/or in an acquisition finance context, as some initial market brainstorming seems to suggest. ■

1 In Project Brainwave, Ashurst partner Carloandrea Meacci led the Ashurst team, together with, among others, the co-authors of this article: senior associate Francesca Brilli and associate Nicola Toscano. Special thanks to Ashurst partner Derwin Jenkinson, who advised on the international capital markets aspects of Project Brainwave, for his contribution to this article.

Further reading

- Acquisition financing for the Sausalitos group: the creation of a cleared unitranche acquisition and capex bond [2014] 11 JIBFL 720
- Sadara project sukuk: heralding a new era? [2014] 3 JIBFL 165
- Lexis PSL: Banking & Finance: Financing a project with a bond issue

CLIFFORD CHANCE

In Practice

Authors Mark Campbell and Toby Mann

All change: the new LMA interest rate provisions

Few clauses of a syndicated loan are more fundamental than those which determine its interest rate. For decades these have been mere boilerplate with the use of screen rates (such as LIBOR or Euribor) with a fallback to rates provided by reference banks and an ultimate backstop of a lender's cost of funds the well established market standard. However, LIBOR's discontinuation for certain currencies and tenors in 2013 led to unexpected issues with, and the consequent reworking of, these provisions in the LMA recommended forms. This article examines those issues and the solutions proposed in LMA documentation.

DISCONTINUATION OF LIBOR FOR AUD, CAD, DKK, NZD AND SEK

LIBOR's discontinuation for these currencies has meant that some institutions may wish to use other (primarily domestic) benchmarks for pricing new loans in those currencies. Two innovations address the potential use of such other benchmarks:

- In accordance with market practice, LMA documentation has assumed the use of either LIBOR or Euribor. The revised documentation features a framework which facilitates the adaptation of the documents to the use of other benchmarks. It provides for the relevant changes to be set out in a schedule without requiring changes to be made to the main body of the agreement.
- New slot-in schedules provide suggested drafting for some domestic interest rate benchmarks (BBSY (BID), BBSW, BKBM (MID), CDOR, CIBOR and STIBOR).

NO REFERENCE BANK QUOTATIONS

Concurrent with the discontinuation of LIBOR for the above currencies was increasing reluctance of institutions to act as reference banks: perceived conflict with the requirement for confidentiality in the new LIBOR code of conduct, a desire for objective rates and increased risk aversion in the aftermath of the LIBOR fixing scandal were among the most prominent causes. This led to operational difficulties as loans in these currencies fell to be priced by reference to each lender's individual cost of funds. The revised form of LMA facility documentation addresses this unexpected difficulty with the reference bank rate-setting fallback in three ways.

- *Replacement of screen rate*: In many cases the preferred medium term solution to the discontinuation of LIBOR for the currency of a loan was amendment of the loan to replace LIBOR with another screen rate for the relevant currency. In a number of circumstances however such an amendment required all Lender consent which proved difficult to obtain. Accordingly the revised LMA documentation now allows for replacement of an unavailable screen rate with majority Lender (and borrower) consent only.
- *New intermediate rate-setting fallbacks*: With use of reference banks potentially difficult the revised documentation allows for the use of historic screen rates as the initial fallback when screen rates (and interpolation) are unavailable. Whilst the use of an historic screen rate which is, by definition, out of date is clearly not ideal this is ameliorated to some degree by (i) controls on how old the historic screen rate is permitted to be and (ii) using the historic screen rate for a short period of time only. Important to note is that, by their nature, historic screen rates will only be a solution for short term problems with a screen rate.
- *Improvements to the reference bank mechanic*: reference banks are retained as a further fallback with amendments addressing some of the recent difficulties:
  - Some institutions feel able to provide quotations only on the same basis as they do in their capacity as contributors to screen rates. Accordingly reference banks are asked to provide their quotations on that basis.
  - Exculpatory provisions go some way towards addressing concerns around reference bank liability.
  - Some institutions which contribute to screen rates feel unable to provide reference bank quotations in the absence of express confidentiality provisions. Accordingly the Agent is required to keep reference bank quotations confidential.
  - To increase the availability of potential quotations reference banks are no longer required to be lenders.

DIFFICULTY WITH COST OF FUNDS

The principal problem with the ultimate backstop of pricing loans by reference to each Lender's cost of funds proved to be the sheer administrative burden involved, particularly with large syndicates. The revised LMA documentation retains cost of funds as the ultimate fallback but allows for the loan to be priced by reference to the weighted average of each cost of funds rate supplied, resulting in a single uniform interest rate applicable to each lender and easing the potential administrative difficulties.

A SMORGASBORD

Reflecting the market's difficulty in reaching consensus on what are tricky issues, the majority of these new provisions are presented as options in the revised LMA facility documentation. It is likely that an established practice will emerge over time. For now, however, it will be necessary to select those options which reflect the commercial agreement in any given case. ■

Biog box
Mark Campbell is a partner and Toby Mann is a senior PSL in Clifford Chance's finance practice. They advised the LMA on the revisions to the interest provisions in its recommended form of facility documentation described in this article.

JONES DAY®

In Practice

Author Liz Saxton

What should an insurance broker say to a lender?

This article considers the ongoing trend to negotiate significantly the terms of insurance broker letters in real estate finance transactions.

Lenders whose main collateral for a secured loan constitutes real estate assets will obviously want to ensure that sufficient insurance cover is in place in case of any damage to, or loss of, those assets. If there is, for example, a fire which causes significant damage to the property, not only will this adversely affect the sale value or "refinanceability" of the property, but it may also result in a loss of rental income, so lenders could face both a fall in the value of their collateral and a borrower which cannot service the interest on the loan.

It is therefore standard practice for a borrower to be required to provide evidence of its insurance as a condition precedent to funding and also to undertake, on an ongoing basis, to maintain that insurance. There will be additional requirements if the financing is for the development of the property.

It has become market practice to request a letter from the borrower's insurance broker (and sometimes also directly from the insurance company), confirming that the insurance is on risk and in full force and effect, rather than simply asking the borrower to provide evidence of insurance (such as an insurance certificate). Over time, lenders have also asked for a variety of rather wider confirmations, including the following:

- that the policy conforms to the requirements of the facility agreement;
- that nothing in the terms and conditions of the insurance policy conflict with the confirmations given in the letter;
- that the insurance cannot be rendered void, voidable or unenforceable against the finance parties by reason of non-disclosure;
- that there is no duty, condition or obligation on the security agent to notify the insurer of any vitiating act;
- that the broker will notify the security agent directly if the insurer proposes to cancel the policy;
- that the insurances provide cover against those risks, and at those levels, which a prudent company would take out; and
- an opinion that the broker anticipates no difficulty in renewing the insurances for further annual periods at appropriate premiums.

Lenders also usually request that the letter is addressed to all of the finance parties at the date the letter is issued, and to any future assignees/transferees.

Insurance brokers have become more focused on the potential additional exposure (ie in addition to their exposure to their client, the borrower) which is created by these letters, for which they may not be separately remunerated. They will be keen to ensure that they are not inadvertently acting as additional credit support for the loan, rather than as broker arranging insurance for their clients.

As with many situations in the world of finance, there is a balance to be struck between competing interests and there are risks which need to be allocated amongst the parties. Here the balance is between the interests of lenders in the validity and value of the insurance (which has been arranged by the broker) and the concerns of the broker that it has simply acted on the instructions of its customer, and does not wish to take on extensive obligations to third parties (ie the lenders).

It is now therefore common for the terms of broker letters to be significantly negotiated documents, and lenders and insurance companies are also spending more time on agreeing the terms of the mortgagee protection clauses contained in the underlying insurance policies themselves, especially those which relate to non-vitiation and no duty of disclosure.

The main points of contention on the broker letter are as follows:

- brokers wishing to put a cap or other limit on their liability under the letter (often by reference to the amount of their liability to the borrower);
- brokers wishing to address the letter only to "day one" finance parties;
- brokers no longer providing an opinion that the insurance risks and levels are "prudent", and indeed expressly stating that they provide no assurances as to the adequacy of the sums insured;
- brokers expressly stating that they provide no view and assume no liability as to the solvency or ability to pay of the relevant insurance companies; and
- brokers either no longer confirming that they see no difficulty in renewing the insurances, or caveating this opinion by reference to the claims experience at the time and there being sufficient insurance capacity in the market.

Insurers frequently attempt to limit the protections for lenders which relate to issues of disclosure, so that (a) they do not apply if the security agent is a mortgagee in possession; and (b) the security agent is obliged to notify the insurer as soon as reasonably practicable after becoming aware of certain defined, limited "disclosable events".

As lenders become more concerned, usually based on unhappy experiences, to obtain independent third party confirmation of the value and efficacy of the insurance which is taken out by their borrowers, and insurance brokers become more aware of the potential liabilities involved in issuing extensive letters to third parties, the negotiation of insurance broker letters looks set to continue as a significant element of real estate finance transactions for some time to come. ■

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OLSWANG

Olswang LLP is a law firm with a pre-eminent reputation in the TMT and real-estate industries. The firm has more than 100 partners across eight international offices.

In Practice

Authors Charles Kerrigan and Ruth Marken

TMT finance: part I

This is the first in a series of four articles. This article will introduce the subject of TMT finance. The second article will consider the terms of loan agreements to IP-rich businesses. The third article will consider the terms of security documents for IP-rich businesses. The fourth article will consider developments in the TMT finance market.

The technology, media and telecoms (TMT) sectors now account for a rapidly increasing share of the UK economy (TMT in London alone accounts for 8% of UK GDP). The businesses within the sectors are all diverse, from technology start-ups to multi-national telecoms companies. All businesses in these sectors, however, are rich in intellectual property and other intangible assets (and often have few valuable tangible assets). This common characteristic is (or should be) relevant to the type and terms on which they are financed. This is important as the global economy will continue to develop around technology and all businesses will be increasingly reliant on new technology to retain and develop market share. By way of example (and there are very many), travel agencies used to be shops; and publishing businesses used to be factories full of printers.

"TMT finance" is the financial and legal business of: (a) lending to businesses in the TMT sectors; (b) lending against intellectual property (IP) and other TMT assets (telecommunications infrastructure, media content, data etc); (c) structuring cashflows from rights, royalties and other IP; and (d) developing electronic money. Traditionally, lending to businesses in the TMT sectors was done by banks on a cashflow lending basis. It was not substantially different from cashflow lending in other sectors. Now TMT finance is developing distinctively. This is a result of a number of factors:

- new lenders (funds, specialist banks and crowdfunding platforms) have entered the market;
- existing senior lenders wish to increase market share;
- the TMT sectors are growing out of the recession (a Barclays survey this year found UK technology companies predicting growth of 11% over the year) and there is an increasing stream of new technologies;
- governments are prepared to design policy and provide funding to support TMT.

Conventional senior lenders can find lending to IP-rich businesses challenging:

- it is difficult for a lender to acquire the expertise to know whether new technology which drives value and cashflows in all these diverse types of businesses will be successful;
- regulatory capital costs are high because of risks (or perceived risks) of impairment; and
- the model of lending used by most domestic bank lenders does not easily accommodate high pricing including upside pricing to take account of this risk.

TMT finance has evolved to take account of a number of factors:

- prospective borrowers are fast growth and change quickly;
- valuable businesses are created in sectors without long histories;
- assets in the sector are intangible, contractual or IP;
- asset valuations are imprecise since there is often no comparable or liquid market for a sale;
- lenders balance a wish to lend at an early stage (and cement a relationship with a growth business) against ensuring that debt is serviceable and there is valid security over valuable assets.

The role of law firms may be broader than in a conventional debt deal. Firms can be asked to use commercial as well as debt lawyers:

- to consider the industry and business risks facing the borrower, not just the terms of the debt;
- to advise on regulation, as there is often a specific regulatory landscape (TV, publishing, telecoms, e-commerce, crowdfunding etc) which needs to be taken into account when structuring and pricing the deal;
- to advise on the position of the lender in the transaction as a whole including work-out strategies suitable to the specific assets and sub-sector, not just the terms of the documents.

This requires an equal and co-ordinated approach by a debt lawyer and a commercial lawyer specialising in the relevant part of the sectors.

TMT finance is designed to achieve:

(1) *Better credit decisions*, so far as the law firms can assist in this:
  - an alignment between the law firm and the lender's decision-makers so that the law firm can understand the key risk elements in the lender's decision and provide for each transaction a package of advice from the law firm, including:
    - a view of issues affecting the relevant sub-sector (regulatory change, new entrants etc);
    - a view of commercial issues specifically affecting the prospective borrower business (IP, litigation, counterparty issues etc); and
    - practical guidance on the likely route to an exit for the lender, in particular if the loan becomes distressed, preserving the value of the intangible assets and other

TMT specific assets.

The role which may be required of a law firm by a lender in TMT finance can extend across the life of the lending relationship given the potential impact at each stage of IP rights:

creditanalysis|structuring|documentation|operational|exit

(2) *Assistance for in-house lawyers and risk managers*, to set institutional policies for acceptable deal structuring. This covers:

- risk management best practice – lenders in the sectors often have specific credit policies for different parts of the sectors so TMT finance requires an understanding of the risk parameters for a particular lender and an application of these to a prospective borrower;
- IP lending protocols – protecting IP and registering security interests requires a balancing of the value of the IP, the risk to the IP, the cost of registrations and the international reach of registrations. Different lenders will accept positions in different places on the spectrum but that spectrum needs to be defined;
- tax and transfer pricing – the international nature of IP rights, the differential IP tax rates across jurisdictions and the structure of royalty payment streams present upside and downside risk for lenders and must be analysed case by case.

(3) *Industry best practice*, through communication, including among the various working groups now being established by various stakeholders (to be considered further in the fourth article in this series). ■

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Competition Law Update

Authors **Becket McGrath** and **Trupti Reddy** of Cooley (UK) LLP

Regulatory scrutiny of the retail banking market

This article considers recent developments in the UK in relation to the ongoing market investigation into banking services for small and medium enterprises.

On 6 November 2014, the UK Competition and Markets Authority (CMA) announced that it had decided to initiate a full market investigation of the supply of retail banking services to personal current account holders and to small and medium enterprises (SMEs). The CMA is now conducting its investigation, which is due to conclude by 5 May 2016.

BACKGROUND

Under the Enterprise Act 2002, the CMA may subject a UK market to a detailed investigation where it has reasonable grounds for suspecting that any of its features prevent, restrict or distort competition.[1] If the CMA's investigation indicates that its initial suspicions were well-founded (ie it finds that there is an "adverse effect on competition" (AEC) in any market investigated), the CMA has extensive statutory powers to impose remedies to address its concerns. These extend to the power to regulate prices and to impose structural remedies on market participants, up to and including divestments of assets or entire businesses.

Although the initiation of the retail banking market investigation marks a new, and very intensive, phase of regulatory scrutiny of the sector, it is itself the product of extensive preparatory work. Back in June 2013, the CMA's predecessor authority, the Office of Fair Trading (OFT), announced that it would be conducting a market study of SME banking. (Such a study is a preliminary step before a full market investigation can be launched.) Although at the outset the OFT noted simply that it would "work closely" with the Financial Conduct Authority (FCA),[2] the study subsequently became a joint CMA and FCA product. In March 2014, shortly before it took over the OFT's competition functions, the CMA announced that it would also undertake a "short update" of previous work by the OFT on personal current accounts (PCA) services, thus effectively combining the SME and PCA workstreams into one project.[3]

The CMA ultimately announced in July 2014 that it was "minded to refer" the markets for personal current accounts and SME banking for a full market investigation, on the grounds that they were "not working well for customers". As required by statute, the CMA's preliminary decision was put to public consultation. Although some respondents (including the four largest banks) raised objections, the CMA unsurprisingly confirmed the market investigation reference. It also confirmed that it would simultaneously review the undertakings entered into by nine banks in 2002, following the last market investigation of SME banking, given the significant overlap with the subject matter of the new investigation.

SCOPE OF THE MARKET INVESTIGATION

For the purposes of the market investigation, the provision of banking services to SMEs[4] includes, but is not limited to, the provision of business current accounts, overdrafts, general purpose business loans and deposit accounts. It specifically excludes the provision of other non-lending products such as insurance, merchant acquiring, hedging and foreign exchange. PCA services comprise the provision of a sterling bank account marketed to individuals offering facilities to hold deposits, to receive and make payments by cheque and/or debit card, to use ATMs and to make regular payments by direct debit and/or standing order, as well as (where used) the provision of overdraft facilities.

The CMA is now considering in more detail a number of preliminary competition concerns that it identified during its market studies. According to the CMA's Issues Statement,which maps out the scope of the investigation, the CMA is focusing on three possible features of the market (or "theories of harm") which could be preventing, restricting or distorting competition: (i) that there are impediments to customers' ability to effectively shop around, choose and switch products or suppliers, which result in weak incentives for banks to compete for customers on the basis of price, quality and/or innovation; (ii) that concentration gives rise to market power of some banks leading to worse outcomes for customers; and (iii) that barriers to entry and expansion lead to worse outcomes for customers. As the CMA has acknowledged, there are strong interrelationships between these three hypotheses and it has noted that it may find an AEC based on features identified under separate theories or harm or indeed on another basis altogether.

NEXT STEPS

The CMA inquiry team is now in full information-gathering mode, with the CMA's website indicating that it is undertaking consumer surveys and site visits. Hearings will be held over the summer, after which the next major milestone in the investigation will be publication of the CMA's Provisional Findings, which is due by September. Once

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that has been published, attention will switch to discussion of potential remedies (assuming that one or more competition concerns have been identified), with the CMA indicating that it will publish its final report in April 2016, ahead of the 5 May 2016 statutory deadline.

INTERACTION WITH OTHER REGULATORS AND POLICIES

The banking sector is complex and highly regulated. In deciding what remedial action, if any, to take, the CMA will need to be mindful of pending changes in the wider regulatory framework. These include, for example, the implementation of the EU Payment Accounts Directive, aimed at increasing the information available on products and charges, as well as new legislation to increase the availability of SME creditworthiness information.

Concerns have already been raised by some stakeholders about the type and cost of remedies which could be implemented, particularly if they are structural in nature. While the CMA has stated that it recognises the significant costs associated with structural remedies, it continues to consider that it is important for all remedy options to remain open, and that it is premature to rule any out. A specific point was raised regarding the undesirability of possible structural remedies in the light of the structural reforms currently under consultation relating to ring-fencing. The Prudential Regulation Authority (PRA) is required[5] to make policy to implement the ring-fencing of core UK financial services and activities. The CMA has noted that it will remain in contact with the PRA regarding the timetables for the ring-fencing reforms. However, it currently sees no grounds to believe that ring-fencing would or should preclude any structural remedies, or that a market investigation would or should preclude implementation of ring-fencing.[6]

The UK banking sector has been subject to almost continuous regulatory and competition scrutiny for more than 15 years.[7] This intensified, however, after the financial crisis of 2008 (and the ensuing bailouts) significantly raised the political temperature, leading to a plethora of reviews and investigations, by an increasing number of authorities. As a result, in addition to working with the PRA to ensure its market investigation, and any potential remedies, take into account the ring-fencing reforms, the CMA will also have to liaise with the FCA and the new Payment Systems Regulator (PSR) to avoid conflict with their concurrent works and to take into account the views and experience of the FCA and PSR.

The FCA has already carried out extensive work into the manner in which competition in various markets in the financial services sector is working, and published a number of market studies. The FCA has just launched a market study in the credit card market. It has also recently published its final market study report into cash savings products, which found that there is little transparency in the market regarding alternative products, customers find it difficult to switch accounts, and large PCA providers have considerable advantages because they can attract most easy access balances despite offering lower interest rates. The FCA is currently consulting on remedies to give consumers sufficiently clear and targeted information on alternative products, simplify the switching process, and remove the advantages that large PCA providers enjoy.

Other work already undertaken by the FCA includes steps to reduce regulatory barriers faced by new bank applicants who may provide more competition in the future; a programme of work to promote competition and innovation by making it easier for start-ups and established businesses to bring innovative ideas into financial services markets; and a review of the Current Account Switching Service.

The PSR, which will become fully operational in April, will focus on ensuring effective competition and innovation in the systems and infrastructure that underpin retail banking, with aims including opening up access to payment systems and establishing a process to drive industry strategy development. The PSR will also have concurrent powers to apply general competition law. The PSR is currently examining access to payment systems and developing policy proposals to address concerns similar to those considered by the CMA in the market studies. HM Treasury is currently consulting on the payment systems that it proposes to designate as payment systems which the PSR will oversee.

The CMA has stated that it will maintain a collaborative approach to working with the FCA and PSR, that it has taken into account work already undertaken by the FCA, and that it agrees with the views of the FCA and PSR that any market investigation should avoid duplicating the work of other regulators and that work should be co-ordinated as far as appropriate. It is understood that the staff supporting the CMA's market investigation include at least one secondee from the FCA, presumably to assist with policy co-ordination and knowledge transfer.

The combination of the CMA's market investigation and the increasing number of market studies and consultations being undertaken by the FCA and PSR will ensure a busy few years for banks and their advisers. The potentially wide-reaching remedies which may be implemented at the end of these processes, as well as the proposed ring-fencing reforms, could have a significant impact on the whole sector, both from the perspective of the banks and consumers. Whether any such measures succeed in resolving the central conundrum of retail banking, namely that customers tend to stay with their existing lenders even while appearing to be dissatisfied with the service that they receive from them, remains to be seen. ■

1 Section 131, Enterprise Act 2002.

2 The FCA has an operational objective to promote competition in the interests of consumers. From April 2015, it will also have full powers to enforce general competition law in the financial sector, which will be exercised concurrently with the CMA. These will include the power to make its own market investigation references under the Enterprise Act 2002, which it cannot currently do.

3 The conclusions of which were published in January 2013.

4 An SME is defined by the CMA for the purposes of this investigation to mean a business that, in respect of a given financial year applying to it, has annual sales revenues (exclusive of VAT and other turnover-related taxes) not exceeding £25m.

5 Under FSMA, amended by Financial Services (Banking Reform)Act 2013.

6 See the CMA's decision on market reference.

7 The CMA Issues Statement notes four major reviews since the Cruickshank Report in 2000.

EU Update

Author **Aikaterini Theodosopoulou**

The Advocate General's Opinion in *Gauweiler*: a glance at the final decision of the CJEU on OMTs

This article provides an overview of the Advocate General's Opinion in *Gauweiler* (Case C-62/14) together with a critical evaluation of his conclusions.

On 14 January 2015, the Advocate General (AG) of the European Court of Justice (CJEU) Cruz Villalón unveiled his long-awaited Opinion on the compatibility of the Outright Monetary Transactions (OMTs) programme of the European Central Bank (ECB) with the Treaty on the Functioning of the European Union (TFEU). The AG's Opinion was issued in the context of a preliminary ruling, at the request of the German Federal Constitutional Court (BVerfG). Whereas the AG's Opinion is not binding and the final ruling of the court has yet to follow, the AG's Opinion is likely to generate debate around two issues: first, the margin of discretion of the ECB in the exercise of monetary policy; and second, the role of the ECB in the Troika.

This commentary provides an overview of the AG's Opinion in *Gauweiler* (Case C-62/14), followed by an attempt to critically evaluate his conclusions. This commentary is divided in four parts: part 1 provides an account of the BVerfG's questions; part 2 analyses the AG's reasoning for the admissibility of the case; while part 3 reflects on the technical features and conditions for the activation of OMTs as explained by the AG. Finally, part 4 offers brief concluding remarks prompted by the recently announced Expanded Asset Purchases Programme (EAPP).

THE QUESTIONS REFERRED

On 7 February 2014, the BVerfG made its first ever reference to the CJEU for a preliminary ruling under Art 267 TFEU. The BVerfG's decision was a product of months of deliberations on a petition filed by German citizens and a party of the German parliament questioning the OMT's lawfulness. The BVerfG's decision to stay proceedings and to refer the matter to the CJEU, for a preliminary ruling, reflected profound disagreements among the eight judges, two of whom delivered dissenting opinions.

The BVerfG sought to ascertain whether the decision of the Governing Council of the ECB of 6 September 2012 on OMT technical features was compatible with Arts 119 and 127(1) and (2) of the TFEU, and with Arts 17-24 of the ESCB Statute to the extent that, as alleged, it exceeded the monetary policy mandate of the ECB laid down in the aforementioned provisions and encroaches upon the competence of the member states. Subsidiarily, and in case the CJEU does not consider the "decision" at question to be an act of an institution of the EU (for lack of jurisdiction to adjudicate upon acts which have no legal effects, cf C-8/66, para 91), the BVerfG sought a declaration on whether the said Articles can be interpreted in such a way as to allow the ECB to execute OMTs.

ADMISSIBILITY

It should be noted from the outset that OMTs were atypical in that no OMT legal framework was ever formally adopted, nor were OMTs ever actually activated. What was, effectively, challenged was an ECB Press Release – which is not a legal act – setting out the main parameters of an eventual OMT programme.

The AG found that the ECB now includes public communications among its key *monetary policy tools*. In his view, "the communications strategy of central banks has become one of the central pillars of contemporary monetary policy". The AG explained that, "taking account not only of the reputation of central banks and the information available to them but also of the powers afforded them by conventional monetary policy *instruments, announcements, opinions or statements by the representatives of central banks generally play a crucial role in the development of monetary policy today*" (para 87). The AG went on to say that, "in the specific case of actions of this kind by the ECB, in which acts of public communication assume special significance for the effectiveness of monetary policy, an act such as the one called in question by the BVerfG... *constitutes* – having regard not only to its content and the actual effects that it may produce but also to the circumstances in which the measure was adopted – *an act of an institution whose validity may be called in question* (para 90)". Therefore, for the purposes of a preliminary ruling, and given the special character of central bank communications, which can be classified as "atypical acts", the AG rejected the objection of inadmissibility raised by a number of member states and institutions, which participated in the proceedings.

IS THE OMT PROGRAMME LAWFUL?

The AG reiterated that the ECB enjoys a high degree of functional as well as organic independence (paras 107-113, 187), intended to keep it away from the political debate. In his view, disentanglement from any sort of political influence is necessary because of the extremely technical nature and high degree of specialisation inherent in monetary policy (para 109). He urged the courts to "exercise a considerable degree of caution when reviewing the ECB's activities" because they lacked the central bank's expertise and experience (para 111).

In light of the above, the AG attempted to describe an OMT programme that would be in conformity with the Treaties. First and foremost, he clarified that OMTs are exceptional measures, to be activated only when strictly necessary (para 179). In his view, OMTs do not entail a circumvention of the monetary financing prohibition of Art 123 TFEU, as long as they are implemented in a way that entails quantitative limits (para 199), allows a market price to be formed in respect of the government bonds concerned (para 252) and, finally, the ECB has taken precautions to avoid both the risk of losses and any distortion of the market for government bonds (para 245). The *pari passu* status of the ECB does not necessarily mean that OMTs amount to a circumvention of the Treaties (para 183, 237). In all cases, the programme has to observe the principle of proportionality, especially on account of exceptional circumstances (para 161). Last but not least, a future OMT would have to identify (in conformity with Art 296(2) TFEU) the exceptional and extraordinary circumstances that led to its adoption (para 165).

The AG concluded that, "in view of the facts and the objectives put forward by the ECB before the court, there are sufficient grounds for considering that the stated objectives of the OMT programme *may in principle be accepted as legitimate*" (para 138).

Moreover, the AG found that the OMT programme objectives clearly classify the programme as a monetary policy measure and not as an economic policy one. In the AG's reading of *Pringle* (C-370/12), monetary policy forms part of general economic policy but a monetary policy measure does not become an economic policy measure merely because it may have indirect effects on the economic policy of the Union and the member states (para 129). The programme's "conditionality" or "selectivity", ie the link with countries under a macroeconomic adjustment programme or a precautionary programme of the European Financial Stability Facility/European Stability Mechanism (ESM), does not have any material influence on the classification of the OMTS as a monetary policy tool (para 145).

THE ROLE OF THE ECB IN THE TROIKA

Although it is not the first time that the court endeavoured to chart the contours of tasks entrusted to the ECB in the ESM Treaty, the AG re-assessed the nature of the ECB's involvement in the Troika, from the perspective of the eventual launch of an OMT programme. The AG opined that the ECB's role in financial assistance programmes goes beyond simply unilaterally endorsing them (para 143). The ECB has an important – not to say decisive – role to play in the design, adoption and regular monitoring of those programmes. Hence, were the ECB to purchase debt instruments of member states under a financial assistance programme, it could only do so provided it had no direct involvement in the work of the Troika (para 146).

It is noted, however, that in *Pringle* the CJEU held that "the duties conferred on the Commission and ECB within the ESM Treaty, important as they are, *do not entail any power to make decisions of their own*. Further, the activities pursued by those two institutions within the ESM Treaty *solely commit the ESM*" (para 161).

It would seem unorthodox to suggest that financial assistance programmes originate with the ECB when the ESM Treaty (cf Art 13) speaks only about the advisory function of the ECB to the ESM Board of Governors. The contradiction is so blatant that one may want to speculate on the likelihood of the court following the opinion of its AG in *Gauweiler* – as this would effectively be for the court to overrule itself, less than two years after delivering its seminal ruling in *Pringle*. One would expect that the EUCJ will, at the end, part company with its General Advocate's opinion in this matter.

THE WAY AHEAD: THE EAPP

In a landmark decision, the ECB announced on 22 January 2015, the launch of an Extended Asset Purchase Programme – a programme distinct from the OMT – which would involve purchases of sovereign bonds. While a legal act had yet to be adopted at the time of writing, the *press communique* described a programme with a (big) nominal figure attached to it, not (entirely) open-ended (the envisaged end date is October 2016 or in any case until the Governing Council sees a sustained adjustment in the path of inflation), with issuer ceilings (one-third of a country's debt issuance) and a partial loss sharing regime in place. Most importantly, the current economic analysis seems to support this bold move.

The AG's findings are likely to cast a shadow over actions of the ECB with regard to monetary policy tools. One way to understand the implications of this Opinion is that legal considerations are now high on the agenda. The ECB is likely to take note of the Opinion when finalising the legal acts, in order to avert future successful litigation. ■

Biog box

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Cases Analysis

Andrea Monks, **Julie Patient**, **Rachel Savary**, **Hugh Lyons** and **Ricci Potts** of Hogan Lovells report on the latest banking law cases

IMPORTING RIGHTS AND REMEDIES AVAILABLE TO BORROWERS UNDER CCA 1974 REGULATED AGREEMENTS INTO UNREGULATED AGREEMENTS

NRAM plc v JP McAdam & A Hartley

[2014] EWHC 4174 (Comm)

SUMMARY

The Commercial Court held that the rights and remedies available to borrowers under Consumer Credit Act 1974 (CCA 1974) regulated agreements should be imported into unregulated agreements, on the basis that they were documented as though they were CCA 1974 regulated agreements. This case has a significant impact on lenders, who might find themselves in unwitting breach of "regulations" which are not applicable at law but are imported as a matter of contract.

BACKGROUND

Before 6 April 2008, consumer credit agreements for an amount of credit exceeding £25,000 fell outside of the scope of the Act. The financial limit operated to create an important distinction between regulated and unregulated agreements. Many firms distinguished their unregulated and regulated lending operations but in order to streamline systems certain lenders used the same forms and processes for regulated and unregulated lending. Borrowers with credit agreements within the scope of the CCA 1974 benefitted, and continue to benefit, from a number of rights and remedies contained in the provisions of the CCA 1974 and related legislation. Section 77A of the CCA 1974 (introduced by the Consumer Credit Act 2006 and in force from 1 October 2008) requires lenders to provide borrowers with periodic statements for regulated fixed sum credit. Such periodic statements must contain the information and wording prescribed by the Consumer Credit (Information Requirements and Duration of Licences and Charges) Regulations 2007, also in force from 1 October 2008.

The sanctions for failing to comply with the requirements of s 77A of the CCA 1974 have a potentially significant impact on lenders. Under s 77A(6) the consequences of the lender's failure to provide a compliant periodic statement within the specified time limits are significant. During a period of non-compliance the lender cannot enforce the agreement. In addition the borrower is not liable for any interest payments calculated by reference to the period of non-compliance and the borrower has no liability to pay any default sum that becomes payable during the period of non-compliance or that would have become payable at the end of that period in connection with a breach of the agreement during that period (regardless of whether that breach continues after the end of that period).

FACTS

Between 1999 and March 2008, NRAM (formerly Northern Rock (Asset Management) plc) entered into a number of unsecured credit agreements. Some were within the CCA 1974 financial limit of £25,000 and were CCA 1974 regulated (the "regulated agreements"). Some exceeded the CCA 1974 financial limit and were not intended to be CCA 1974 regulated (the "unregulated agreements"). The same documentation was used for both the regulated and the unregulated agreements. This documentation included repeated references to the loans being CCA 1974 regulated, across the Pre-Contract Information, the Mortgage Application, the Offer of Loan and the Loan Agreement. More specifically, the documentation stated that the borrower would have the benefit of the protections of the CCA 1974. In addition NRAM made no distinction in the on-going administration of the loans.

The issue in this case was, therefore, whether the rights and remedies available to borrowers under the CCA 1974 (or equivalent protections) should be imported into the unregulated agreements on the basis that they had been documented as though they were regulated agreements.

Section 77A of the CCA 1974 requires lenders to provide periodic statements with prescribed wording and information. NRAM failed to meet these obligations in respect of all customers with this type of mortgage loan, both those with regulated and unregulated agreements. When NRAM identified the issue it voluntarily remediated in respect of the regulated agreements taking steps to refund interest and default charges which had been paid during the period of non-compliance. However, NRAM did not refund any interest or default charges where the original agreement was in excess of £25,000 on the basis that the sanction in s 77A(6) of the CCA 1974 would not apply to unregulated agreements. This position was challenged and as a result NRAM sought a declaration from the court on whether borrowers would remain liable to pay interest and default charges during the period of non-compliance.

The defendants argued that although the unregulated agreements were, in fact, unregulated, NRAM, by their references to the CCA 1974 in the loan documentation, had effectively agreed to give the defendants the rights and benefits available under the CCA 1974 and "to treat them as if it was a regulated agreement (so far as possible)." The terms of the CCA 1974 were incorporated into the contract through express reference to it.

NRAM's opposing view was that because the unregulated agreements were exactly that – unregulated – references to the CCA 1974 in the loan documentation "must be disregarded as inappropriate or immaterial… and the court should… treat the statements in the [unregulated agreements] referring to the [CCA 1974] as notionally qualified by the words 'if applicable'". The loans were entered into before s 77A was inserted into the CCA 1974. On this basis, NRAM further argued that even if the parties intended for the loan to be treated as if it were an agreement regulated at the present time by the CCA 1974, the parties would not have intended that all "future vagaries" of the CCA 1974 were to be incorporated. Additionally, NRAM argued that in order for the loans to be treated as if they were regulated agreements, both parties would need to have expressly known that they were not regulated agreements. However, in this case, the defendants believed that they were regulated.

HELD

Mr Justice Burton held that the unregulated agreements should be construed as if they were CCA 1974 regulated and so the s 77A CCA 1974 rights and remedies would be imported into the unregulated agreements. Burton J was not attracted by NRAM's argument that the reference to the CCA 1974 should be disregarded. He considered that those parts of it which were inapplicable should be disregarded, but not all references to the statute. He also considered that the legislation to be incorporated by way of reference in the documentation was the relevant legislation, as amended from time to time, as he considered that it was a basic feature of the consumer credit regulatory environment that such legislation would evolve over time. He did not agree with NRAM that both parties had to know that the agreement was not regulated, in order to treat the loan as if it was a regulated agreement. He considered that parallels could be drawn with judgments on contractual estoppel in which parties could agree on a state of affairs whether or not the state of affairs was correct. He therefore found that the defendants were given the rights and benefits of a regulated agreement whether or not they were regulated agreements for the purposes of the CCA 1974.

Accordingly, NRAM was found to be in breach of its obligations under the unregulated agreements as it had failed to indemnify borrowers further to its failure to comply with s 77A of the CCA 1974. Such rights and remedies entitled borrowers under the unregulated agreements to the interest and charges they had paid during the period of non-compliance and as a result the borrowers with unregulated loans had been improperly excluded from the refund programme.

This decision runs contrary to the generally held view by experts in this area, such as Goode, that "if [one] cannot lawfully contract out of the [CCA 1974], they cannot contract into it either". NRAM has confirmed that it will seek leave to appeal the decision.

COMMENT

This judgment has surprised many in the industry, and will impact on other lenders who may have used the same documentation for both CCA 1974 regulated agreements and unregulated agreements. This practice was thought to be fairly commonplace (as acknowledged by Goode and by the court in this case) although more likely with agreements originated before the removal of the financial limit in 2008. With the increase in regulation and the abolition of the financial limit many lenders are likely to have taken steps to distinguish between loans falling outside of the scope of the CCA 1974 from those within.

Until any appeal reverses the effect of this judgment, lenders will need to consider whether they have used regulated forms for unregulated agreements and if so, whether they have complied with the relevant provisions of the CCA 1974. This would go beyond just the requirement to provide a compliant annual statement and would also impact other processes such as those taken on default. The judgment will also potentially impact other unregulated agreements such as those entered into by incorporated entities if a regulated form was used, although in this situation it is common for lenders to include an express disclaimer to ensure that the corporate entity acknowledges that the protections of the CCA 1974 will not apply. ■

Andrea Monks, Julie Patient and Rachel Savary

FAILURE TO DISCLOSE COMMISSION FALLS WITHIN S 140(1) OF THE CCA 1974

Plevin v Paragon Personal Finance Ltd and another

[2014] UKSC 61

FACTS

The claimant took out a loan with the defendant (the "Lender") under which she was to make monthly repayments. The loan was arranged by a broker (the "Broker") and accordingly the claimant had no direct contact with the Lender save for one telephone call which took place for anti-money laundering compliance purposes. As part of this transaction the Broker arranged for the claimant to take out payment protection insurance (PPI) with the Lender's designated

Cases *Analysis*

PPI provider. The premium for the PPI was paid in one upfront payment, which was added to the sum borrowed. The Lender paid commission to the Broker in respect of both the loan and the PPI and itself received commission from the PPI provider. As a result, 71% of the PPI premium paid by the claimant was commission received by the Broker and the Lender. The level of commission was not disclosed to the claimant.

Subsequently the claimant brought claims against the Broker and the Lender in respect of the PPI element of the transaction, which she alleged had arisen from an unfair creditor/debtor relationship within s 140A of the Consumer Credit Act 1974 (CCA 1974). The claim against the Broker was settled but the claim against the Lender proceeded to trial.

FIRST INSTANCE PROCEEDINGS

The claimant argued that the failure to disclose the commission or to assess the suitability of PPI for the claimant made the relationship between the claimant and the Lender unfair within the meaning of s 140A(1)(c) of the CCA 1974 and that in so far as such matters had been the result of defaults by the Broker, it had been acting on the Lender's behalf.

The Recorder hearing the case at first instance dismissed the claim and refused to order any relief under s 140B. She held that the existence of an unfair relationship should be determined in accordance with the relevant regulatory framework namely the Insurance Conduct of Business Rules (ICOB). Accordingly, she found that as ICOB did not require the disclosure of commission to consumers this did not, on its own, give rise to an unfair relationship. She made no finding as to whether the Broker had failed to assess the appropriateness of PPI for the claimant as that duty fell upon the Broker alone and there was no relationship of agency between the Lender and the Broker that would make the Lender responsible for the Broker's failings. Accordingly, the Broker's actions could not give rise to an unfair relationship as between the Lender and the claimant. The claimant appealed.

COURT OF APPEAL PROCEEDINGS

The Court of Appeal dismissed the appeal in relation to the non-disclosure of the commission but held that s 140A(1) of the CCA 1974 extended to all conduct beneficial to the creditor in the sense that it played some material part in bringing about the transaction in question. Accordingly, notwithstanding the lack of an agency relationship between the Lender and the Broker, the Broker's actions could still be treated as being "on behalf of" the Lender for the purposes of s 140A(1). The Court of Appeal therefore remitted the case to the county court to determine whether the Broker had failed to assess the suitability of the transaction for the claimant's purposes. The Lender appealed.

DECISION

The Supreme Court upheld the decision of the Court of Appeal but essentially reversed the grounds of the decision. Lord Sumption, giving the only reasoned judgment with which all the other Lords agreed, found that s 140A of the CCA 1974 was framed in wide terms and depended upon the court's judgment of all the relevant facts. Accordingly an unfair relationship could be found even where the terms of the agreement upon which that relationship was based were not intrinsically unfair. He found that while a relationship could be unfair because the relationship was so one sided as to substantially limit the debtor's ability to choose it was not the case that a general inequality of financial knowledge and expertise would necessarily give rise to an unfair relationship.

The Supreme Court disagreed with the Court of Appeal, and overruled that court's decision in *Harrison v Black Horse Ltd* [2012] Lloyd's Rep IR 521, by finding that the considerations which were relevant for the purposes of s 140A were wider than those relevant for ICOB. Relevant considerations included: the characteristics of the debtor; the facts which a person could be reasonably expected to know or assume; the range of choices available to the debtor; and the extent to which the creditor was or should have been aware of those facts. In particular, it was not necessary for there to have been a breach of duty by the creditor for an unfair relationship to have been created. Accordingly, it was not necessarily a defence for the Lender to say that it was not under an obligation to disclose the commission under ICOB, if the lack of disclosure could still result in an unfair relationship between the creditor and the debtor. The Supreme Court further found that where unfairness arose as a result of an omission the creditor would normally be responsible for that omission if it had failed to take such steps as it would be reasonable to expect it, or someone acting on its behalf, to take in the interests of fairness and those steps, if taken, would have removed the source of the unfairness or mitigated its consequences.

Applying these criteria the Supreme Court determined that any reasonable person would have questioned whether a transaction in which more than two thirds of the premium paid was commission was providing true value for money to the claimant. The Lender was the only party who knew the full amount of the commission to be paid and therefore was in a unique position to remove the source of the unfairness by disclosing to the claimant the amount of commission and therefore its failure to do so fell within s 140A(1)(c). Accordingly, the claim should be remitted to the county court to determine what relief, if any, should be ordered under s 140B of the CCA 1974.

On the other hand, the Supreme Court found that the Lender's failure to assess the suitability of PPI for the claimant did not make the creditor/debtor relationship unfair. The Supreme Court noted that the Lender had not made a personal recommendation of PPI to the claimant and accordingly was not obliged to assess the suitability of PPI under the ICOB rules. The Supreme Court found that (in contrast to the position on disclosure of commission) where ICOB had specifically assigned the responsibility for assessing the suitability of PPI to another party, namely the Broker, it was not reasonable to expect the Lender to conduct its own assessment.

It then fell to be decided whether, as the Court of Appeal had held, the Lender could be liable for the Broker's failure to assess the suitability of PPI for the claimant on the basis that the Broker was acting "on behalf of" the Lender. The Supreme Court found that while s 140A was intended to create a broad definition of unfairness which extended beyond the specific terms of the agreement between the creditor and the debtor to include any human action giving rise to an unfair relationship, the only limitation on the breadth of this definition were the words "by or on behalf of the creditor".

The Supreme Court found that generally the words "on behalf of" imported a relationship of agency and that there was nothing in the relevant section to suggest that a wider meaning was required: the Supreme Court noted that where the Act sought to impute responsibility to the creditor for another's actions it did so in express terms. It followed that as it was accepted that the Broker was not acting as the Lender's agent the Lender could not be liable for actions of the Broker which might be said to have given rise to an unfair relationship.

Accordingly, the claimant had no case against the Lender in relation to the assessment of suitability of PPI and the order remitting the case to the county court on that basis could not stand.

COMMENT

It will be of concern to lenders that they cannot merely rely on their compliance with the relevant regulations but will instead need to investigate the particular circumstances of each case. This case is a good example of the potential uncertainty this can cause for lenders. In various consultation papers the Financial Services Authority had suggested that disclosure of commissions might not be necessary and that their disclosure could cause confusion and information overload for the customer. However, it seems that in the current case the size of the commissions and the circumstances of the debtor were such that disclosure was required in order to avoid an unfair relationship.

While this is bound to cause increased uncertainty for lenders it is arguably preferable to a situation in which lenders might be found liable for regulatory breaches by intermediaries who were not acting as the lender's agent. This is particularly true when it is considered that in many cases there will be more than one intermediary acting on a particular transaction. In those circumstances the administrative burden on lenders of supervising several intermediaries is likely to be significant. This may be of particular concern for large institutions who are more likely to be solvent than their intermediaries and therefore a more appealing target for a claim. ■

Hugh Lyons and Ricci Potts

NORTON ROSE FULBRIGHT

If you wish to contact Norton Rose Fulbright with regard to any item on this update please contact Simon Lovegrove on +44 20 7444 3110 or email Simon.Lovegrove@nortonrosefulbright.com

Regulation Update

A round-up of regulatory changes by **Norton Rose Fulbright**

FOCUS OF THE FCA

On 13 January 2015, the Financial Conduct Authority (FCA) provided an update on its website concerning the steps it will take to transpose MiFID II.

The FCA stated that it is likely that its formal consultation on Handbook changes will not take place until the end of 2015. However, the FCA will be engaging on certain aspects of the changes ahead of this formal consultation. In particular, the FCA stated that it expects to issue a discussion paper towards the end of Q1 2015 which will seek views on various issues relating to conduct of business.

The FCA also stated that HM Treasury is looking to issue a consultation in Q1 2015. The FCA mentioned that the topics covered by the HM Treasury consultation will be disparate but will include:

- changes to the boundaries of UK regulation through amendments to the Regulated Activities Order;
- an authorisation regime for data reporting service providers;
- changes to the FCA's supervisory powers (including for position limits);
- implementing the third country branching provisions; and
- changes to the requirements to be met by recognised investment exchanges.

EBA CONSULTS ON ITS ON PROVISION OF INFORMATION FOR RESOLUTION PLANS UNDER BRRD

The Bank Recovery and Resolution Directive (BRRD) mandates the European Banking Authority (EBA) to draft, amongst other things, implementing technical standards (draft ITS) to specify the procedures and minimum set of standards, forms and templates by which information may be provided for the purposes of resolution plans.

On 14 January 2015, the EBA published a consultation paper in which it set out these draft ITS. Article 2 of the draft ITS set out a procedure that shall apply where resolution authorities require information about an institution in order to draw up a resolution plan.

The minimum set of forms and templates provided in Annexes I to XII of the draft ITS cover in particular the information listed in Annex B of the BRRD concerning the institution's organisational structure, governance and management, critical functions and core business lines, critical counterparties, structure of liabilities, funding sources, off-balance sheet, payment systems, information systems, interconnectedness, authorities and legal framework. The deadline for comments on the consultation paper is 14 April 2015.

FCA AND PRA IMPLEMENTING THE BRRD

On 16 January 2015, the FCA published Policy Statement 15/2: Recovery and Resolution Directive: Feedback on CP14/15 and final rules (PS15/2).

In PS15/2 the FCA summarised the feedback it received to its earlier consultation on implementing the BRRD and set out the final rules (which did not differ significantly from the draft rules which were consulted on).

The FCA's final rules entered into force on 19 January 2015, except IFPRU 11.6 on the contractual recognition of bail-in which will come into force on 1 January 2016. The reporting of recovery plans will be phased in from the end of June 2015.

On the same date the Prudential Regulation Authority (PRA) published Policy Statement 1/15: Implementing the Bank Recovery and Resolution Directive – response to CP13/14 (PS1/15).

The PRA made a number of points in PS1/15 including that it had updated its Supervisory Statement on Recovery Plans. It also stated that it would not require third-country branches to provide individual recovery plans. However, where the PRA is concerned that the whole group plan is not able to deliver against the PRA's objectives, the PRA may, in the course of its host state prudential supervision of the branch, request a UK branch recovery plan.

The PRA's final rules came into force on 19 January 2015, except for the rule to require contractual clauses in eligible debt instruments, which came into force on 19 February 2015.

Regulation Update

ASSESSING CAPITAL ADEQUACY UNDER PILLAR 2 – CP1/15

On 19 January 2015, the PRA published Consultation Paper 1/15: Assessing capital adequacy under Pillar 2 (CP1/15).

The PRA has already consulted on certain changes to the Pillar 2 framework (Consultation Paper 5/13: Strengthening capital standards: implementing the CRD IV) and published final policy (Policy Statement 7/13: Strengthening capital standards: implementing the CRD IV). In CP1/15 the PRA set out further proposals which continues the reform of Pillar 2 covering:

- Pillar 2A methodologies;
- how the PRA intends to operate a new buffer regime;
- how weak governance and risk management under Pillar 2 should be tackled; and
- the impact of the Pillar 2 reforms on capital disclosure and how a more transparent regime can be created.

The deadline for responding to CP1/15 is 17 April 2015.

DEAR CEO LETTER – THE FCA'S EXPECTATIONS OF HIGH-COST SHORT-TERM LENDERS

On 21 January 2015, the FCA published a Dear CEO letter regarding its expectations of high-cost short-term credit lending (HCSTC) firms.

In the Dear CEO letter the FCA summarised a number of concerns that it has uncovered in the course of supervising HCSTC firms since April 2014.

In particular the FCA is concerned that high levels of re-lending or high levels of arrears and default may indicate that a firm is failing to undertake adequate affordability assessments at the outset. HCSTC firms are reminded that they will need to demonstrate in their applications for authorisation that they have proper processes in place, with appropriate governance and controls including monitoring and reporting requirements, to make suitable lending decisions.

The FCA also identified concerns about the way HCSTC firms are treating customers in financial difficulties. It reminded firms that: (i) customers in default or arrears difficulties should be treated with forbearance and due consideration; (ii) firms should not unfairly limit or constrain customers' access to appropriate forms of forbearance; and (iii) firms must ensure that all communications with customers, through all channels, are clear, fair and not misleading.

PROGRESS IN ADOPTING THE PRINCIPLES FOR EFFECTIVE RISK DATA AGGREGATION AND RISK REPORTING

The Basel Committee on Banking Supervision's (BCBS) Principles for effective risk data aggregation and risk reporting (the Principles) were issued in January 2013 and are designed to strengthen risk data aggregation and risk reporting practices at banks so that risk management practices are improved.

The BCBS and the Financial Stability Board expect global systemically important banks (G-SIBs) to comply with the Principles by 1 January 2016. The BCBS also strongly suggests that national supervisors apply the Principles to domestic systemically important banks three years after their designation as such.

The BCBS is monitoring G-SIBs' progress towards meeting the 2016 deadline. On 23 January 2015, the BCBS published a report regarding the progress made in adopting the Principles which included an update on an earlier "stocktaking" self-assessment survey completed by G-SIBs, other large banks and national supervisors. Notably, of the 31 participating banks, 14 have reported that they will be unable to fully comply with the Principles by the 2016 deadline.

IOSCO PUBLISHES FINAL REPORT ON RISK MITIGATION STANDARDS FOR NON-CENTRALLY CLEARED OTC DERIVATIVES

On 28 January 2015, IOSCO published a final report entitled *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives*.

In the final report IOSCO set out nine standards aimed at mitigating the risks in the non-centrally cleared over-the-counter (OTC) derivatives markets. Each standard is accompanied by key considerations that describe how the standard should be implemented. The report stated that authorities should seek to introduce regulatory requirements or guidance implementing each standard in a way that is consistent with the key considerations.

The risk mitigation standards cover the following key areas:

- trading relationship documentation and trade confirmation;
- process and/or methodology for determining valuation;
- portfolio reconciliation;
- portfolio compression; and
- dispute resolution.

Regulation Update

REVISED PILLAR 3 REQUIREMENTS ISSUED BY THE BASEL COMMITTEE	On 28 January 2015, the BCBS published its final standard for the revised Pillar 3 disclosure requirements. The revised requirements will take effect from end-2016. They supersede the existing Pillar 3 disclosure requirements first issued as part of the Basel II framework in 2004 and the Basel 2.5 revisions and enhancements introduced in 2009.
COUNCIL OF THE EU ENDORSES AML PACKAGE	On 27 January 2015, the Economic and Financial Affairs Council endorsed an agreement reached with the European Parliament on the proposed Fourth Money Laundering Directive and the proposed Regulation to amend and replace the Regulation on information on the payer accompanying transfer of funds. The European Parliament is expected to vote on the texts in March or April 2015.
ESMA PUBLISHES OPINION ON DRAFT RTS ON THE CLEARING OBLIGATION FOR INTEREST RATE SWAPS	On 18 December 2014, the European Commission published a letter notifying the European Securities and Markets Authority (ESMA) that it was going to endorse, with amendments, the draft regulatory technical standards (RTS) on the clearing obligation on interest rate swaps. Within six weeks from the Commission's notification, ESMA may amend the draft RTS and resubmit it in the form of a formal opinion to the Commission. On 29 January 2015, ESMA published a formal opinion containing a second version of the draft RTS which addressed a number of changes introduced by the Commission. In particular ESMA: - agreed with the ultimate objectives of the modifications that the Commission intends to introduce; - supported the Commission's intention to extend the initial approach with the objective of postponing the start date of the frontloading obligation, as this should provide counterparties with sufficient time to determine whether their contracts are subject to the frontloading obligation; - raised some concerns on the process envisaged to exempt non-EU intragroup transactions from the clearing obligation; and - proposed to incorporate the suggestion of the Commission to deal with the application of the EUR 8 billion threshold to investment funds for the definitions of types of counterparties as a specific provision in the text of the RTS.
GUIDANCE ON ACCOUNTING FOR EXPECTED CREDIT LOSSES ISSUED BY THE BCBS	On 2 February 2015, the BCBS published a consultative document containing draft guidelines on accounting for expected credit losses. The draft guidelines set out 11 fundamental principles with commentary which are designed to set out supervisory requirements on sound credit risk practices associated with the implementation and on-going application of expected credit loss accounting models. The deadline for comments on the consultative document is 30 April 2015.
ESMA TECHNICAL ADVICE ON POSSIBLE DELEGATED ACTS CONCERNING MAR	On 3 February 2015, ESMA published a final report containing technical advice on possible delegated acts concerning the Market Abuse Regulation (MAR). The final report is divided into five main sections: - specification of the indicators of market manipulation; - minimum thresholds for the purpose of the exemption for certain participants in the emission allowance market from the requirement to publicly disclose inside information; - determination of the competent authority for notification delays in public disclosure of inside information; - managers' transactions – type of transactions to report and trading during a closed period; and - reporting of infringements. The final report also contained, for each question included in the earlier consultation paper, a summary of the market participants' responses, as well as ESMA's own comments to the responses received. The delegated acts should be adopted by the Commission so that they enter into force 24 months after the entry into force of MAR, taking into account the right of the European Parliament and Council of the EU to object to a delegated act within three months (which can be extended by a further three-month period).

Market Movements

DLA Piper UK LLP reviews key market developments in the banking sector

Domestic banking

From 2016 the Prudential Regulation Authority (PRA) will oversee rigorous new stress tests involving simulated crisis situations. Unlike earlier stress tests the disaster scenarios will not just focus on the housing market but on situations tailored to particular banks, making it more difficult for banks not exposed to house price fluctuations to pass – *Independent, 3 February 2015*

Barclays has begun pilot schemes offering virtual banking services using iPads in London, Norfolk and Sunderland. Virtual branches in places such as community centres and nursing homes will allow customers to conduct most banking activities apart from paying in or withdrawing cash and cheques – *Times, 9 February 2010*

RBS and **NatWest** customers who have an iPhone 5S, 6 or 6 Plus are now able to get into their bank accounts online by the touch of a finger. In what the bank maintains is a first for Britain, customers are now able to access their bank accounts online with the use of Apple's Touch ID fingerprint sensor – *Theguardian.com, 18 February 2015*

The London Bullion Market Association has appointed **Standard Chartered** as a market-making member. It joins 13 other members who must provide quotations for buying and selling gold and silver to the other market makers during London market hours – *Independent, 10 February 2015*

Domestic general

The Financial Conduct Authority (FCA) has raised questions over whether corporate clients are being offered good value for money by investment banks and has announced that it will be undertaking a wide-ranging market study of the industry. Asset management, financial data and trade clearing services will also be examined. The FCA said that opaque pricing and significant barriers to entry for competitors can result from the cross-selling and bundling of investment banking services – *Telegraph.co.uk, 19 February 2015*

The issue of Britain's future relationship with Europe is splitting the City of London. Investment banks on the one side are looking to retain the City's place as a financial centre and so are pushing for Britain to maintain its position within the EU, whilst on the other side some hedge funds are backing the exit campaign and pointing to what they call expensive and time-consuming regulation. The Government is considering whether a referendum on Britain's membership of the EU can be brought forward from 2017 to 2016 – *Financial Times, 9 February 2015*

In a legal opinion given to the Treasury select committee, Jonathan Fisher QC has supported the FCA's assertion that it does not have the power to act on thousands of small business loans which had "embedded" interest-rate swaps. The opinion should help banks avoid another multi-billion pound mis-selling compensation pay-out – *Independent, 7 February 2015*

Data from Dealogic shows that, in the past four years, British banks have been responsible for over \$50bn of leveraged loans – high-yield, non-investment grade debt – to the oil and gas industry. As a result, the ongoing collapse of the oil price could leave a number of the banks sitting on losses running to billions of dollars – *Sunday Telegraph, 25 January 2015*

European banking

In response to regulatory pressure to reduce the size of bonuses, **Deutsche Bank** is to review the pay received by its analysts, associates and vice-presidents with a view to increasing remuneration. **Credit Suisse** has also increased the salaries of some of its junior employees in light of the EU bonus cap which limits bonus levels to twice a banker's annual salary – *Financial Times, 18 February 2015*

Following a year of lower fines and reduced legal costs **Deutsche Bank** has reported a €438m post tax profit for the final quarter of 2014, as revenue rose by a fifth. The bank reported a loss of €1.36bn at the same time last year – *Independent, 30 January 2015*

After taking on the role of regulator to the Eurozone's bigger lenders in late 2014, the **European Central Bank** (**ECB**) has notified banks that it will carry out a thorough examination of their bonus policies in coming months. It has warned banks that they should not be distributing too much capital via shareholder dividends or staff bonuses – *Times, 30 January 2015*

Market Movements

The **ECB** has surprised investors by launching a larger than expected quantitative easing scheme, as it looks to counter deflation and revitalise the economy in the Eurozone. The €60bn-a-month bond-buying programme, which will begin in March, will see the bank spend over €1trn by September 2016 on buying assets such as government and private sector bonds. The scheme is fiercely opposed by business and political leaders in Germany, who fear it could lessen the pressure on European countries to carry out reforms of their economies – *Financial Times, 23 January 2015*

One in four retail customers who have switched current accounts since 2013 have moved to **Santander**. In 2014 alone 276,000 customers switched to **Santander UK**, whilst balances in current accounts increased to £41.1bn, a rise of over £13bn. Pre-tax profits also went up by over a quarter last year, up from £1.1bn to £1.4bn. The UK has overtaken Brazil as the bank's biggest market – *Times, 4 February 2015*

UBS has reported a higher than anticipated profit of SWFr 963m for the last quarter of 2014. It has however warned that future profits could be harmed by the increase in value of the Swiss franc and negative interest rates – *Times, 11 February 2015*

European general

Just a few months after it bought the Spanish operations of **Barclays**, Spain's third-largest lender, **CaixaBank**, is to launch a full takeover bid for **BPI**, its Portuguese rival, where it is already the largest shareholder with a 44.1% stake. **CaixaBank** has offered €1.329 per share – *Telegraph, 18 February 2015*

Austria's **Erste Group** is on the brink of selling as much as 30% of the bank's Hungarian operations to the Hungarian government and the **European Bank for Reconstruction and Development.** The move would tighten the Hungarian government's grip on a banking sector which suffered crippling losses following the financial crisis in 2008 – *Financial Times, 10 February 2015*

European banks have warned that tough capital rules aimed at curbing risks in securitisation will weaken the effects of the **ECB**'s new €1.1trn quantitative easing program – *Financial Times, 27 January 2015*

International banking

Goldman Sachs and **Société Générale** are in discussions with **Aztec Money** to move into the peer-to-peer lending sector. **Aztec Money** has developed an online platform where bids are made for company invoices. The move illustrates the desire of traditional investment banks to move into peer-to-peer financing which was originally set up to bypass these kinds of institutions – *Financial Times, 29 July 2015*

The encroachment made by **Lazard** into a sector normally dominated by bigger Wall Street rivals, has been underlined by the investment bank's 2014 figures, which show that its revenues for merger and acquisition advisory topped $1bn for the first time in its history – *Financial Times, 6 February 2015*

International general

A new global survey by PricewaterhouseCoopers has shown that cyber-attacks are one of the most pressing issues concerning the chief executives of banks and capital markets. Seventy-nine per cent of the 175 bosses surveyed said that they were either concerned or extremely concerned over their company's growth prospects being impacted by cyber threats. In comparison, the figure for chief executives across all industries stands at 61% – *Telegraph, 17 February 2015*

According to security company Kaspersky, one of the most sophisticated cyber-attacks ever aimed at the finance industry could have hit up to 100 banks and other financial institutions. The exact range and extent of the attacks is still being investigated. There has been no confirmation of how much money was actually stolen, but Kaspersky has estimated losses of $1bn – *Financial Times, 16 February 2015*

As financial institutions around the globe race to shore up their capital buffers in the face of demands from regulators, banks in China have emerged as the top issuers of riskier loss-absorbing debt instruments. According to research by Moody's, a collective $59bn in contingent convertible (coco) bonds were issued by Chinese banks in 2014, a third of the total global volume – *Financial Times, 12 February 2015*

Regulators in the United States are expanding investigations into possible foreign exchange rigging and are examining whether the set-up of electronic trading platforms at some big banks, which allowed a "latency period" between an offer being made and then being accepted, could have led to clients losing out in currency deals – *Independent, 11 February 2015*

Banks in China have been allowed to cut the amount of money held in reserves by the **Central Bank of China** in a bid to improve bank lending and fight against the slowdown in the economy. The reserve ratio requirement has been reduced to 19.5%, a drop of 0.5%, for the first time since May 2012 – *Independent, 5 February 2015* ■

QUOTE OF THE MONTH:

"Financial institutions who are proven to have colluded with tax evaders should face the full force of the law."

Danny Alexander, Treasury Chief Secretary; FT 10/2/15

Deals

Our monthly round up of industry news, major transactions, their significance and the players involved

Slaughter and May, working as a team with **Paul, Weiss, Rifkind, Wharton & Garrison LLP**, is advising Non-Standard Finance plc (NSF) in connection with its proposed initial public offering. NSF has been established to acquire and operate one or more non-standard consumer financial services businesses and intends to raise approximately £100m from a placing of its shares with institutional and professional investors. The Slaughter and May team was led by partners Andy Ryde (Corporate) and Jan Putnis (Financial Regulation). The Paul, Weiss, Rifkind, Wharton & Garrison LLP team was led by partner Mark Bergman.

Herbert Smith Freehills has advised the Government of India, as vendor, on the US securities and international capital markets aspects of a US$3.6bn share sale by Coal India Ltd on the Bombay Stock Exchange and the National Stock Exchange of India. The deal is the third largest equity capital markets deal in India ever and the largest share sale in the country in almost six years. The Herbert Smith Freehills team on the deal was led by Singapore partner Siddhartha Sivaramakrishnan.

Clifford Chance has advised HSH Nordbank AG on the SME securitisation of trade receivables acquired in Germany, Sweden and Switzerland by ABS Global Factoring AG from local originators via Smart Fact SA, a securitisation company in Luxembourg. The team was led by partner Dr Arne Klüwer and comprised senior associate Mortimer Berlet and associate Klara Klaushenke (all Banking & Capital Markets, Frankfurt).

Allen & Overy has advised Crédit Agricole Corporate and Investment Bank and Sumitomo Mitsui Banking Corporation on the refinancing of the 150 MW Houay Ho cross-border hydropower project located in the Lao People's Democratic Republic. Stephen Jaggs (Partner), and Sarah Wilson (Senior Associate) led the Allen & Overy team from Bangkok with support from lawyers Vorasaree Wangwittaya, Monsicha Pongrujkorn, Isabelle Whitehead and Vitita Subhawat.

Ashurst acted for investment firm Ares Management on the unitranche financing of the acquisition of Polo Motorrad und Sportswear GmbH by financial investor Equistone. The German retailer of motorcycle clothing and accessories was sold by German financial investors Paragon Partners and Tempus Capital. The financing of the acquisition was provided by Ares Capital as a so-called unitranche financing. The unitranche was structured as bond. The Ashurst team was led by Munich finance partner Dr Bernd Egbers.

Shearman & Sterling advised Citigroup Global Markets Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated and Morgan Stanley Senior Funding, Inc, as joint lead arrangers and joint bookrunners, in connection with a $900m multi-currency refinancing for Aon plc, Aon Corporation and Aon UK Ltd. The Shearman & Sterling team included partners Joshua Thompson (New York-Finance), Caroline Leeds Ruby (London-Finance), and Larry Crouch (Palo Alto-Tax).

Leading global law firm **Mayer Brown** advised SME-investor Halder on the financing of its acquisition of PRAE-TURBO through a management buy-out. PRAE-TURBO, located in Schwanewede/Germany, focuses on machining compressor wheels for automotive turbochargers. The Mayer Brown team working on the transaction included partner Markus Strelow (Lead), counsel Alexa Metzger as well as senior associate Marc Bäumer (all Banking & Finance, Frankfurt).

King & Wood Mallesons has advised GCG Renewable Energy Infrastructure Fund GmbH & Co KG (REIF), a fund advised by Munich-based Goodyields Capital GmbH, on a portfolio financing of onshore wind and solar PV assets, both existing and under construction, located in France, Italy and Sweden. The financing was granted by a German pension fund and was structured to best serve the interests of REIF's institutional investors. The financing documentation was drafted in such a way that typical credit processes such as collateral provision or payment procedures could be simplified considerably by using a group-perspective taking into account all project companies. The King & Wood Mallesons team was led by partner Clemens Niedner (Financing, Frankfurt).

Global law firm **White & Case LLP** has advised HSBC, as Global Coordinator and Sole Bookrunner, in connection with ORPAR's issue of €170m zero coupon bonds, due 2019, exchangeable for existing Rémy Cointreau ordinary shares. ORPAR, controlled by the Heriard Dubreuil family, holds 50.23% of the Remy Cointreau's share capital and 66.08 percent of its voting rights. The White & Case team in Paris was led by capital markets partners Thomas Le Vert and Séverin Robillard, with support from counsel Elsa Imbernon and associate Petya Georgieva. Tax partner Alexandre Ippolito and associate Marcus Schmidbauer advised on the tax aspects.

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WHEN AN OFFERING CIRCULAR IS INCONSISTENT WITH UNDERLYING CONTRACTS: *US BANK TRUSTEES V TITAN*

The *Titan* case (*US Bank Trustees Ltd v Titan Europe 2007-1 (NHP) Ltd and others* [2014] EWHC 1189 (Ch)) arose out of the question as to which party was entitled to require the removal and replacement of the special servicer on the Titan Europe 2007-1 (NHP) Ltd commercial mortgage-backed securitisation. Here we focus on two wider practical questions for capital markets practitioners arising from the consequences of discrepancy between the offering circular and a transaction document it discloses: which document prevails in the event of a dispute, and when can prospectus liability arise?

Which document prevails?
Offering circular vs servicing agreement

The disclosure set out in the *Titan* offering circular led to the controlling party entitled to require the removal and replacement of the special servicer being identified as the representative of the holders of the most junior class of notes. According to the terms of the servicing agreement this right was instead expressed to be held by the issuer of the notes. Importantly, a further contractual document – the A/B intercreditor agreement between the lenders of the securitised portion of the loan (the "A"-loan) on the one hand and the lenders of the non-securitised portion of the loan (the "B"-loan) on the other – was on all fours with the servicing agreement.

The primacy of contract

For the judge, it was an "obvious proposition" that any analysis of the identity of the controlling party entitled to serve notice requiring the termination of the appointment of the special servicer was a question of interpretation of the servicing agreement. He explained that while the offering circular is an important part of the matrix against which the servicing agreement must be construed:

- the A/B intercreditor agreement was a contractual document which, as between the parties to it, required the servicing agreement to take a particular form;
- the offering circular was not a contractual document; and
- any force that the offering circular might otherwise have had as an aid to construction of the servicing agreement was minimised by the terms of the disclaimer it contained that: "*The obligations of the parties to the transactions contemplated herein are set forth in and will be governed by certain documents described herein, and all of the statements and information contained herein are qualified in their entirety by reference to such documents.*"

It was held that, as it made at least equal commercial sense for the issuer as against the noteholders to be the controlling party (the issuer was a lender under the relevant loan), the terms of the servicing agreement did not generate a commercially absurd result; therefore, as the servicing agreement was unambiguous, its ordinary meaning prevailed.

When does prospectus liability arise?

As part of his judgment, Richard Snowden QC (sitting as deputy judge of the High Court) stated: "*[A]t the end of the day my task is to construe the contractual documents in accordance with the recognised principles of interpretation […] If the result is that the Offering Circular did not accord with the contractual documents, then this may simply have the result that Noteholders might have claims in respect of the Offering Circular.*" *Titan* did not discuss this issue further, but it raises the general question for practitioners as to when incorrect statements in an offering document can give rise to liability and what managers and persons responsible for the offering circular can do to protect themselves.

FSMA, s 90

The most relevant provision for an investor seeking compensation is s 90 of the Financial Services and Markets Act 2000 which provides that each person responsible for the prospectus is liable to pay compensation to a person who has acquired securities to which the prospectus applies and suffered a loss as a result of any untrue or misleading statement in the prospectus. The person acquiring the securities need not have relied on the statement, merely suffered a loss as a result of it. There is no requirement for the investor to have purchased from the issuer itself, so an investor purchasing in the secondary market may also be able to rely on this provision.

How a manager might protect itself

The manager of a capital markets transaction (as opposed to the issuer of the securities) may mitigate its risk of liability arising out of an incorrect offering circular with one or more of the following:

- undertaking verification and due diligence procedures to ensure disclosure is accurate;
- "responsibility statement" in the offering circular stating that the issuer accepts responsibility for the contents of the document;
- "offeree acknowledgement" that the offering circular does not constitute a representation by the manager as to the accuracy of the information it contains;
- "investor representation letter" in which the investor confirms it has undertaken its own assessment of the securities and has not relied on any statements by the manager in making its decision to purchase;
- as regards preliminary offering circulars, a statement ("red herring" wording) that the document is subject to amendment and completion without notice and that it is an advertisement and not a prospectus for the purposes of EU Directive 2003/71/EC. ■

Further reading

- Fuller, *The Law and Practice of Capital Markets*, 3rd Edn, LexisNexis at para 7.131
- Lexis®PSL Banking & Finance monthly highlights – October 2014