Feature

KEY POINTS

- A series of criteria under Financial Collateral Arrangements (No 2) Regulations 2003 (FCAR) must be met for a security arrangement to qualify for financial collateral arrangements (FCA) status.
- FCAs are exempt from the requirement for security to be registered under the Companies Act 2006 and ordinary principles of insolvency law are modified as regards FCAs, in most cases in favour of the collateral taker.
- Careful consideration should be given when drafting security documents to bring them within the FCA regime; in particular, lenders should ensure they have a sufficient level of practical control of the collateral to ensure that the collateral provider is "dispossessed" of the collateral.
- The debenture must contain a power to appropriate and FCAs need to be evidenced in writing.

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Financial collateral arrangements: tricky issues and practical considerations

Financial collateral arrangements (FCAs) are a mechanism which enable corporate entities to take and enforce security, free from a number of restrictions and formalities which apply to other forms of security. In order to qualify for simplified FCA status, the arrangement must fall within the scope of the Financial Collateral Arrangements (No 2) Regulations 2003 (FCAR). In this article, we explore a number of tricky issues arising from the qualifying criteria under the FCAR and the exemptions applicable to security which qualifies as a FCA. We also provide some practical guidance to lenders when drafting and dealing with FCAs.

KEY FEATURES

Financial collateral arrangements (FCAs) are a form of security arrangement governed by the EU Directive 2002/47 (FCA Directive) designed to simplify the process of having recourse to financial collateral across the EU, and implemented by the Financial Collateral Arrangements (No 2) Regulations 2003 (FCAR) in England and Wales.

"Financial collateral" is defined in reg 3 of the FCAR and covers the following:

- "cash", including money in any currency, credited to an account or a similar claim for repayment;
- "credit claims", meaning pecuniary claims arising out of an agreement where a credit institution grants credit in the form of a loan; and
- "financial instruments" including shares and equivalent securities, bonds and other forms of acknowledgment of indebtedness which are tradeable on the capital markets, and any other securities which are normally dealt in and give the right to acquire such shares, bonds, and instruments, amongst other things which give rise to a cash settlement.

Pursuant to reg 3 of the FCAR, FCAs incorporate both "title transfer financial collateral arrangements" (Title FCAs) and "security financial collateral arrangements" (Security FCAs). There are, therefore, two types of FCA under the FCAR, which have different qualifying elements. In either case, the following criteria must be satisfied:

- the agreement must be evidenced in writing;
- the purpose of the arrangement is to secure the financial obligations of the collateral provider (Provider) to the collateral taker (Taker); and
- the Provider and the Taker must both be non-natural persons.

As the name suggests, a Title FCA arises where the Provider transfers legal and beneficial ownership in financial collateral to the Taker on terms that when the relevant financial obligations are discharged the Taker must transfer title back to the Provider.

On the other hand, a Security FCA is an arrangement where the Provider creates a security interest (or security otherwise arises) in financial collateral to secure the Provider's obligations to the Taker. In the case of a Security FCA, the collateral must be delivered, transferred, held, registered or otherwise designated so as to be in the possession or control of the Taker. A "security interest" can include any legal or equitable interest or any right in security including a pledge, mortgage, fixed charge, floating charge (so long as the collateral is under the possession or control of the Taker) or a lien.

BENEFITS OF A FINANCIAL COLLATERAL ARRANGEMENT

There are a number of benefits to a security arrangement falling within the FCAR, both as a matter of general principle and in an insolvency situation.

General statutory formalities

In particular, FCAs are exempt from a number of general statutory formalities by virtue of modifications set out within the FCAR. The most notable modifications are:

- The requirement for a guarantee to be signed and in writing (s 4 of the Statute of Frauds Act 1677) and the requirement for an assignment of an equitable interest to be in writing (s 53(1)(c) of the Law of Property Act 1925) do not apply. Whilst these two exemptions may at first appear to override trite principles governing contractual arrangements, their practical benefit is severely limited by the requirement (noted above) for FCAs to be evidenced in writing.
- The requirement for charges created by a company to be registered and the consequences for failure to register within 21 days (contrary to ss 859A and 859H of the Companies Act 2006) do not apply. This is perhaps the most important provision of the FCAR as regards simplification of the process of having recourse to financial collateral. However, for the reasons discussed in further detail below, this exemption is widely under-utilised and FCAs are often still registered in practice.

Principles of insolvency law

Part 3 of the FCAR deals with the modification of insolvency law in relation to FCAs. The modifications fall broadly into the following categories.

Amendments to rules relating to the enforcement of security in administration and company voluntary arrangements (CVAs)

The modifications relating to enforcement of security include:

- the statutory moratorium in administration on enforcement of security and repossession of goods (para 43(2) of Sch B1 to the Insolvency Act 1986 (IA86)) does not apply;
- an administrator cannot dispose of property subject to a charge (where that charge is created by or arises under a FCA) as if it were not subject to that charge (c.f. paras 70 and 71 of Sch B1 IA86); and
- a receiver appointed under a FCA by a Taker cannot be required to vacate office upon the later appointment of an administrator in relation to the Provider (para 41(2) of Sch B1 IA86 disapplied).

Amendments to rules relating to the avoidance of contracts and floating charges

The key changes implemented by FCAR include the following:

- dispositions of property which would otherwise have been void under s 127 IA86 (ie dispositions made in the period between presentation of a winding up petition and the making of a winding up order) shall not be void where they relate to any property or security interest which is transferred, created or otherwise arising under a FCA. This means that certain transactions relating to the creation or disposition of a FCA after presentation of a winding up petition will not be void.
- likewise, any transfer of shares under a FCA which would otherwise have been void following the commencement of a voluntary liquidation (under s 88 IA86) will not be void.
- the ring-fencing of a "prescribed part" of realisations from floating charge assets for the benefit of unsecured creditors does not apply to floating charges arising under FCAs (ie s 176A IA86 does not apply).
- floating charges which would otherwise be void under s 245 IA86 (where, for example, security was granted subsequent to a loan being advanced in the relevant period prior to a company entering insolvency) will not be avoided where the floating charge arises under a FCA.
- close-out netting provisions (ie provisions for the obligations of two contractual parties to be accelerated and effectively set off against one another resulting in a net balance payable to one party), shall take effect notwithstanding that a Taker or Provider under the relevant FCA is subject to winding up, administration or a company voluntary arrangement. This provision applies providing that at the time of entry into the FCA, the solvent entity was not aware (and could not have been aware) that insolvency or reorganisation measures had commenced against the other (insolvent) party.

TRICKY ISSUES

Due to the detailed qualifying criteria for FCAs to fall within the scope of the FCAR, there are a number of difficult issues and queries that can arise when dealing with FCAs. In addition, the consequences of the exemptions from statutory formalities and certain insolvency provisions noted above can lead to unintended consequences that can be challenging to resolve. We deal with a few such issues below.

FCAs: what level of control is required?

Regulation 3 of the FCAR provides that property subject to a charge be "delivered, transferred, held, registered or otherwise designated so as to be in possession or under the control of the collateral-taker". However, the FCAR provides no statutory definition as to the meaning of the words "possession" or "control" and this has led to controversy. It has therefore been left to the courts to try and give some clarity.

- In the case of *Re Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch), the High Court held that for a floating charge to qualify as a Security FCA, the Taker had to have sufficient possession or control for the Provider to be "dispossessed" of the financial collateral. Therefore, what was needed was more than just the mere fact of delivery or transfer, but to analyse the terms upon which the Provider had "delivered" or "transferred" the financial collateral to the Taker, in order to establish the Taker's rights to, and that those rights had been exercised over, the collateral.
- More recently in *Private Equity Insurance Group SIA v Swedbank AS* [2016] EUECJ C-156/15, the European Court of Justice (ECJ) helpfully gave some further guidance on the meaning of "possession" or "control"– the financial collateral in this case was cash deposited in a bank account. If the financial collateral is to be kept out of the insolvency estate, the ECJ held that the Taker not only has to have practical control over the bank account, but additionally the right to prevent any cash withdrawal by the Provider which would be contrary to its obligations under the FCA, ie real control.

Interplay with insolvency legislation

One of the key features of a FCA (deriving from the FCA Directive) is the modification of certain provisions of insolvency legislation as detailed above.

In an interesting recent case before the ECJ, the ECJ was asked to consider the ability of a Taker to enforce its security under a FCA, in circumstances where the Provider had defaulted under the FCA only after the Taker has entered insolvency (*Aviabaltika v Ukio Bankas* [2018] WLR (D) 472). The case concerned an inconsistency between Lithuanian national insolvency legislation and the FCA Directive.

Aviabaltika (A) had entered into a FCA with Ukio Bankas (Ukio) whereby A deposited funds (as Provider) into an account in its name with Ukio (the Taker) as security for A's obligations to Ukio under two guarantee issue agreements. A also had separate funds deposited with Ukio which were unrelated to the FCA.

Ukio entered liquidation and A then defaulted on its obligations to Ukio under the FCA. In satisfaction of A's default under the FCA, Ukio did not utilise the collateral held under the FCA (due to a restriction under national legislation which prevented it from doing so) but claimed instead from the separate funds that A had deposited with the bank. A therefore lost both the collateral, which Ukio

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Biog box

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claimed formed part of the liquidation estate, and the funds which A had deposited.

The relevant questions before the ECJ were:

- Are member states obliged to establish legal rules which require that a Taker should be able to obtain satisfaction of its claim from the collateral under a FCA in circumstances where the enforcement event occurred after the commencement of the winding up of the Taker?
- Does the FCA Directive confer on Providers a right to demand that the Taker should primarily obtain satisfaction of its claim for default from the collateral provided under the FCA?

On the first question, the ECJ confirmed that the FCA Directive is intended to ensure that a FCA can take effect, and be enforced, notwithstanding the commencement or continuation of winding up proceedings in respect of either the Provider or the Taker. Member states therefore need to ensure that collateral assets should be excluded from the general pool of assets on the insolvency of a Taker (which could perhaps be addressed by collateral being held on trust for the Provider).

On the second question, the ECJ held that, in the absence of anything in the wording of the FCA to the contrary, a Taker should primarily seek to obtain satisfaction of its claim against the Provider from the collateral held. The FCA between Ukio and A provided that the collateral had been deposited to "ensure the proper fulfilment of the Client's obligations towards the Bank"; therefore it was clearly intended that the collateral should be utilised to discharge Ukio's claims.

To register or not to register: that is the question

Regulation 3 of FCAR provides that ss 859A and 859H of the Companies Act 2006 shall not apply to FCAs, with the consequence that there is no need to register FCAs (which would otherwise be a registrable charge) at Companies House. A FCA will therefore be valid notwithstanding a Taker's failure to register its security.

However, in practice, FCAs are often registered as a matter of course for a number of reasons, not least because of potential uncertainty about the status of the arrangement and whether it falls within the scope of the FCAR. Given the specific requirements for security to be compliant with FCAR, it is not always clear whether an arrangement will qualify as a FCA and therefore whether the requirement to register applies. A charge to which the usual rules apply will need to be registered or otherwise risk being deemed void for lack of registration; consequently, the stakes are high. For example, if the court considered that a lender had insufficient control of the collateral, the arrangement may fall outside the scope of the FCAR and then be void for lack of registration. Registration of security is a simple form-filling exercise which can easily be completed and, given the risks, it will often be deemed preferable to register than risk the consequences.

Additionally, by registering the security at Companies House, third parties are put on notice of its existence which may discourage wrongful interference with the collateral. This is a useful tool to prevent the Provider from utilising the collateral assets in an unauthorised manner without the Taker's consent.

PRACTICAL ISSUES: HOW TO BRING YOUR SECURITY ARRANGEMENT WITHIN FCAR

It is important for a secured lender to pay close attention to the structure and documentation of their lending and security arrangements to ensure that they fall within the scope of the FCAR and qualify as a Taker, to safeguard its position apropos the secured obligations.

In many lending arrangements the borrower/Provider will enter into a debenture which sets out the terms on which it will grant security over all or substantially all of its assets by way of security for the relevant lending. That debenture will create security interests over both cash deposits and shares and securities held by the company, which assets fall within the definition of financial collateral.

The secured lender will wish to include specific drafting in the debenture to deal with financial collateral. Principally, this will be a clause giving the secured lender the right, once its security has become enforceable, to appropriate the financial collateral.

The key practice point here is that the secured lender cannot appropriate if its debenture does not contain that power. This is because the power to appropriate provided for in reg 17 of the FCAR requires the relevant "security financial collateral arrangement to contain a power for the collateral-taker to appropriate".

In addition, where an appropriation clause is included the secured lender will generally also seek to define the "value" of secured assets appropriated. Where the financial collateral is:

- Cash, the "value" will be the face value of that cash at the time the right of appropriation is exercised.
- Financial instruments, it will usually be the market price of those financial instruments at the time the right of appropriation is exercised determined by the secured lender by reference to a recognised market index or by any other method that the lender may reasonably select (including independent valuation).

The secured lender will also require the borrower to agree in the debenture that these methods of valuation are "commercially reasonable" for the purposes of reg 18 of the FCAR. ■

Further Reading:

- Use of a portfolio of securities held by a custodian to provide financial collateral (2016) 3 JIBFL 134.
- Controls on the scope of the Financial Collateral Directive (2016) 9 JIBFL 525.
- LexisNexis Loan Ranger blog: Financial collateral arrangements in the age of uncleared margin.