# When is a lien a charge and how much control is required for a financial collateral arrangement? (High Court)

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The High Court has ruled that a security interest, described as a "general lien" in the document creating it, is in fact a charge, because of the nature of the property over which it was intended to take effect and the rights created in relation to that property. The court also ruled in the same judgment in relation to the interpretation and application of the Financial Collateral Arrangements (No. 2) Regulations 2003 (FCARs) as to the requirements to be met for any financial collateral arrangement to fall within the regime established by the FCARs and therefore receive protection from various forms of statutory invalidity. (*Re Lehman Brothers International (Europe) (In Administration) [2012] EWHC 2997 (Ch) (2 November 2012)*.)

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## Speedread

The High Court has held that a particular security interest should be characterised as a charge not a lien. This decision was made on the basis that the security-taker had a specifically enforceable right to have the relevant property appropriated to the payment or discharge of the relevant obligation. It was, Briggs J said, that right of specific enforcement that transformed the security interest from a lien (a personal right) to a charge (a proprietary interest in the property).

The court held that the charge did not qualify as a "security financial collateral arrangement" under the Financial Collateral Arrangements (No. 2) Regulations 2003 (*SI 2003/3226*). This was because the terms of the charge failed to meet the requirement in regulation 3 that the property be "delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker". The words 'possession' and 'control' were held to mean more than just custody of the security. To qualify as a security financial collateral arrangement the collateral-taker had to have sufficient possession or control for the collateral-provider to be "dispossessed" of the security.

The court also held that there was no requirement that security financial collateral arrangements be bilateral or that the provision of security needed to be the main purpose of the arrangements creating them. (*Re Lehman Brothers International (Europe) (In Administration) [2012] EWHC 2997 (Ch) (2 November 2012)*.)

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## Background

A ***lien (www.practicallaw.com/1-107-6319)*** is one of the four types of security commonly recognised in English law. It is, in essence, a right for one party to keep hold of the property of a second party until the second party has discharged a debt due to the first party. A "general lien", which was the term used in

the document relevant to this case, gives the first party a right to retain property until all debts have been discharged by the second party, whether or not the debts are referable to the property being held. A lien does not, unless altered by agreement between parties, give the party holding property as security a right to sell that property and apply the proceeds in satisfaction of the debt. A lien can operate on all property that can be transferred by delivery. It cannot operate on intangibles. For more information see *Checklist, Security by way of lien: checklist (www.practicallaw.com/2-206-0190)*.

A ***charge (www.practicallaw.com/2-107-5890)***, another class of security recognised in English law, confers upon the chargee an equitable proprietary interest in the charged property, giving the chargee the right to appropriate the charged property and have the proceeds of sale applied in satisfaction of the debt. Any asset which equity recognises as 'property', including intangible property, can be subject to a charge. For more information see *Checklist, Taking security by way of charge: checklist (www.practicallaw.com/0-206-0191)*.

*The Financial Collateral Arrangements (No.2) Regulations 2003 (SI 2003/3226) (www.practicallaw.com/5-383-9404) (FCARs)* are the UK legislation implementing EU Directive 2002/47/EC and came into force on 26 December 2003. They were designed to provide a common regime of minimal formalities for the creation of financial collateral arrangements, for example, removing the requirement for qualifying security financial collateral arrangements to be registered. The scope of the FCARs and their ability to apply to a floating charge has not been tested thoroughly in the courts previously. For more information see *Practice note, Financial collateral arrangements (www.practicallaw.com/8-212-1954)*.

For an overview of taking security by charge, lien or financial collateral arrangement see *Practice note, Taking security (www.practicallaw.com/2-107-4032)*.

## Facts

Lehman Brothers International (Europe) (LBIE) entered into a standard form Master Custody Agreement (the MCA), in August 2003 with an affiliated company, Lehman Brothers Finance SA (LBF). The MCA was originally intended for use between LBIE and its external customers and contained clauses which the court said could "loosely be described as" security provisions granted by LBF in favour of LBIE.

Following the insolvency of the wider Lehman's group (including both parties to the MCA), this case was concerned with the question of whether LBIE could validly claim a proprietary interest in LBF's property held pursuant to the MCA, and if so, which property.

Two features of the security provisions were central to many of the issues considered in the judgment.

- The first feature was that the security provisions in both documents referred to the security they created as a "general lien". However, the security related principally to intangible property, such as de-materialised money and securities. Since a lien can only take effect over tangible property, the court was asked to rule on the true nature of the security interest created by the MCA in order to decide the extent of the property caught by it and what statutory consequences were applicable to it.
- The second feature was that the security created was described as security for debts owed by LBF to LBIE, and also as security for debts owed by LBF to "any Lehman Brothers entity". However, the documents did not expressly establish any trust or agency relationship between LBIE as holder of the security and other Lehman Brothers entities as beneficiaries of the security. Whether the security was considered to extend to other Lehman Brothers entities was relevant to a number of the issues addressed in the judgment including the question of whether the security was within the scope of the FCARs.

## Decision

**The security interest was a floating charge not a general lien**

The court held that the security interest created by the MCA was a floating charge rather than a general lien, both in relation to obligations to LBIE and to other Lehman brothers entities.

- The parties agreed that the vast majority of LBF's property held by LBIE pursuant to the MCA was in the form of intangible property, mainly bank accounts and dematerialised securities. The court found it highly improbable that the parties would have intended to create a type of security interest that was not capable of applying to the vast majority of the property in question.
- Clause 13 of the MCA gave LBIE rights against LBF's property as security for satisfaction of LBF's liabilities and obligations to LBIE and other Lehman Brothers entities. In the event that such obligations were not satisfied, it gave LBIE an express power of sale over the property and the ability to apply money held and the proceeds of any sale in satisfaction of such obligations. The court considered these rights to be the typical attributes of a charge.
- LBF argued that the rights created by clause 13 could not be a charge in respect of LBF's liabilities to other Lehman Brothers entities, because LBIE was neither the creditor, nor a trustee or other fiduciary of the creditor in relation to these liabilities. The court concluded that it was not a necessary characteristic of a charge that the chargee is either the creditor, or a trustee or other fiduciary of the creditor. The necessary characteristic was for the chargee to have a right of specific enforcement for the appropriation of the relevant property in satisfaction of a liability, whether that liability is owed to the chargee or otherwise. The court emphasised that it was a right of specific enforcement over the property that turns what might otherwise be a purely personal right into a proprietary interest, such as a charge. The charge created by clause 13 therefore secured liabilities owed to both LBIE itself and other Lehman Brothers entities.
- Clause 13 of the MCA gave LBF a right to substitute or to demand withdrawal of excess property from the property held by LBIE pursuant to the MCA. LBIE therefore conceded, and the court ruled that, in line with the reasoning in *National Westminster Bank plc v Spectrum Plus Ltd [2005] 2 AC 680, (www.practicallaw.com/8-106-8127)*, the charge created by clause 13 must take effect as a floating charge.

For the wording used in clauses 9 and 13 of the MCA, see box, Key provisions of the MCA.

**The court held that the FCARs did not apply to the MCA.**

The court was asked to address the question of whether the security arrangements contained within the MCA fell within the scope of the FCARs. This section of the judgment focused principally on whether the charges created by the MCA constituted a "security financial collateral arrangement" as defined in the FCARs. The court found this to be a question of interpretation of the FCARs. It was emphasised that, because the FCARs implement an EU directive (Directive 2002/47/EC, the Directive), they should be interpreted, as far as possible, to give them an effect which is consistent with the meaning and purpose of the Directive. See, *box, The definition of "security financial collateral arrangement" given in the FCARs*.

LBF and Lehman Brothers Inc argued that the security constituted by the MCA fell foul of this definition for three reasons:

- The MCA created security in respect of obligations to both LBIE and other Lehman Brothers entities, whereas the phrase "obligations owed to the collateral-taker" in limb (a) of the definition required that the arrangements were bilateral;

- the whole of limb (a) imposed a purpose test which required that the provision of security be a predominant or significant purpose of the relevant arrangements and, it was argued, that was not the case in the MCA; and
- LBIE did not have sufficient control over the collateral provided pursuant to the MCA to meet the requirements of limb (c) of the definition.

**The court found that there was no requirement in either the Directive or the FCARs that the arrangement be strictly bilateral**

The judge accepted LBIE's argument that it would make no sense to infer such a test because it would exclude from the scope of the Directive and the FCARs arrangements which grant security to a trustee for a group of beneficiaries. The judge also remarked that, even if the FCARs did require the arrangements to be bilateral, the MCA met this requirement, in the sense that it was an agreement between two parties which did not confer any direct rights or any proprietary interest on any third party. Therefore, the MCA did not fall outside the scope of the FCARs because of any multilateral character.

**The MCA did not fall outside the scope of the FCARs because of any failure to satisfy a purpose test**

LBF's argument that the FCARs imposed a purpose test required comparison between the FCARs and the language used in the Directive. Article 2.1(c) of the Directive, which defined "security financial collateral arrangement", did not refer to the 'purpose' of the arrangements. Therefore, limb (a) of the definition in the FCARs, if found to constitute a purpose test, would significantly restrict the scope of the EU legislation within the UK.

It was in determining this issue that the court emphasised its obligation to interpret the FCARs so as to give effect to the meaning and purpose of the Directive. As the Directive contained no purpose test, the court was not persuaded by LBF's arguments that the FCARs should be interpreted as containing one. Instead the court found reasons supporting the argument for reading limb (a) of the definition in the FCARs as not imposing a separate purpose test. For example, it may have been included because English law may find the existence of security interests which are created by operation of law rather than express agreement between parties. Therefore, where an express agreement exists, the 'purpose' element of limb (a) is automatically satisfied. Where security arises by operation of law, the reference to 'purpose' means that the relevant arrangements must have been intended to create the security in question. Therefore, the MCA did not fall outside the scope of the FCARs because of any failure to satisfy a purpose test.

**The security under the MCA failed to satisfy the possession or control test**

The phrase "so as to be in the possession or under the control of the collateral-taker" in limb (c) of the definition of "financial collateral arrangements" features in both the FCARs and the Directive. It was interpreted in fundamentally different ways by LBIE and LBF. LBIE submitted that it simply set out the inevitable consequence of the collateral being "delivered, transferred, held, registered or otherwise designated" such that, as long as there had been a delivery, transfer etc of the property in question,

there was no separate test as to how much possession or control the collateral-taker actually exercised. In contrast, LBF argued that there was an additional requirement, similar to that established for distinguishing between fixed and floating charges in the Spectrum Plus case. LBF submitted that, if the collateral-provider remained free to deal with the collateral, or to direct how it was dealt with, pending crystallisation of the charge, then the collateral-taker had insufficient possession and control for the arrangement to fall within the scope of the FCARs.

The judge paid tribute to the extensive evidence presented by both sides in relation to this point. Despite the fact that there was a previous judgment on the same issue in *Gray and others v G-T-P Group Limited: Re F2G Realisations Limited (in liquidation ) [2010] EWHC 1772 (Ch)* (see *Legal update, Have you created a floating charge? Bank accounts held on trust and the Financial Collateral (No. 2) Regulations 2003 (www.practicallaw.com/0-502-7971)*), the judge remarked that in this case the matter had been argued so much more thoroughly, and by reference to so much more evidence, that it was "legitimate and necessary to address the question afresh".

The court found that the inclusion of "so as to be in the possession or under the control of the collateral-taker" in both the Directive and, consequently, the FCARs, imposed an additional requirement. It introduced a need to analyse the terms upon which collateral was delivered, transferred etc in order to identify the parties' rights and whether such rights were exercised. The judge noted that the effect of the FCARs is to disapply statutory requirements, designed to protect creditors, from certain security arrangements. For example, the requirement for security to be registered under what was at the time the FCARs were implemented, section 395 of the Companies Act 1985 (now section 860 of the Companies Act 2006), and the avoidance of certain floating charges under section 245 of the Insolvency Act 1986. The language used struck a balance between making the Directive widely applicable enough to achieve its purpose, yet not granting immunity from such creditor protections where inappropriate.

The court concluded that the critical requirement that the collateral be "in the possession or under the control of the collateral-taker" was for the control exercised by the collateral-taker to be sufficiently extensive for the collateral-provider to be properly described as having been dispossessed. The final sentence of limb (c):

"any right of the collateral-provider to substitute equivalent financial collateral or withdraw excess financial collateral shall not prevent the financial collateral being in the possession or under the control of the collateral-taker", was an example, rather than a comprehensive description, of rights which may remain with the collateral-provider.

LBIE's rights under the MCA were sufficient to qualify under FCARs with respect to liabilities owed to it, but not with respect to liabilities owed to other Lehman Brothers entities. Clause 9 of the MCA gave LBIE a right to retain a collateral pool equal to its estimate of its exposure to LBF. The judge considered that this was sufficient 'possession or control' to meet the requirements set out in the FCARs. LBF was only able to withdraw the property subject to the MCA to the extent that such collateral exceeded LBIE's estimate of LBF's liabilities to it. However, clause 9 did not give LBIE a right to make similar estimates and retain a pool of collateral in respect of LBF's liabilities to other Lehman Brothers entities. It was this fact which meant that, taken as a whole, the rights conferred upon LBIE by the MCA, failed to satisfy the 'possession or control' test. The judge considered whether it was conceptually possible to regard the MCA as creating two distinct securities, one regarding liabilities to LBIE itself and one regarding liabilities to its affiliates. However, he did not favour such an analysis, because the security was created by a single clause and operated over the same property. The result was that LBF retained rights which were substantially greater than a right of substitution or withdrawal of excess collateral. Excepting LBIE's right

to retain a pool equivalent to its exposure, LBF was free to deal with the property subject to the MCA, regardless of its liabilities to other Lehman Brothers entities.

**Other issues relating to the validity and effect of the security**

The court also came to the following conclusions:

- The FCARs were not intended to have retroactive effect. The court concluded that, for the FCARs to be interpreted as having retroactive effect, there must be evidence of a clear intention to legislate retroactively. There was no evidence of this in the case of the FCARs. The MCA was dated a few months before the FCARs came into force, therefore, in the case of the MCA, the FCARs would not apply.
- The fact that LBIE did not exercise its right to retain a collateral pool in respect of debts due to it would not necessarily have prevented the arrangements from qualifying under the FCARs, if the arrangements had not been prevented from doing so for other reasons.
- The phrase "other Lehman Brothers entities" used in clause 13 of the MCA was sufficiently certain to prevent a challenge to the validity of the security created on grounds that the beneficiaries of the security could not be identified. The court recognised that identifying exactly which entities were within the scope of this term might be difficult, but would not be uncertain.

## Comment

This case provides a very helpful analysis of the scope of the FCARs, with in-depth analysis of their meaning and purpose, giving detailed reasoning as to why they do not apply in this case. The judgment makes it clear that the requirement for collateral to be in the 'possession or control' of the collateral-taker is an additional test to the mere fact of delivery or transfer. It also clarifies that the requisite control must exist across all aspects of the security interest. If a party holds security in respect of debts due to it and debts due to its affiliates, the control it exercises must apply in relation to both categories of debt. Interestingly, and in contrast to the test used to distinguish between a fixed and a floating charge, the test under the FCARs appears to be a question of whether rights exist, as opposed to whether they have been exercised.

This case is also a useful reminder of the distinction between different types of security interests and the fact that the type of interest created by a document is a matter of substance as opposed to form.

## Case

*Re Lehman Brothers International (Europe) (In Administration) [2012] EWHC 2997 (Ch) (2 November 2012) (www.practicallaw.com/2-522-7182)*.

## Key provisions of the MCA

Clause 9: "The Client [LBF] may, at any time subject to Section 13 hereof, demand withdrawal of all or any part of the Property in the Custody Account…The Custodian [LBIE] shall have no obligation to deliver the Property of the Client where the Custodian believes that there may be insufficient Property in the Custody Account to cover any exposure that the Custodian has to the Client."

Clause 13: "The Client agrees that the Custodian shall have a general lien on all …Property held by it under this Agreement until the satisfaction of all liabilities and obligations of the Client (whether actual or contingent) owed to the Custodian or any Lehman Brothers entity under any other arrangement entered into which any Person in the Lehman Brothers organisation."

Clause 13 went on to give LBIE the right to sell LBF's property in the event of LBF failing to discharge its liabilities and obligations.

The definition of "Property" in the MCA read "'Property' means as the context requires, any Securities, Precious Metals, cash or any other property held by the Custodian under the terms of this Agreement" and the definition of "Securities" was "bonds, debentures, notes, stocks, shares, units or other securities…(including, without limitation, any of the foregoing not constituted, evidenced or represented by a certificate or other document…)".

## The definition of "security financial collateral arrangement" given in the FCARs

"…an agreement or arrangement, evidenced in writing, where:

(a) the purpose of the agreement or arrangement is to secure the relevant financial obligations owed to the collateral-taker;

(b) the collateral-provider creates or there arises a security interest in financial collateral to secure those obligations;

(c) the financial collateral is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker or a person acting on its behalf; any right of the collateral-provider to substitute equivalent financial collateral or withdraw excess financial collateral shall not prevent the financial collateral being in the possession or under the control of the collateral-taker; and

(d) the collateral-provider and the collateral-taker are both non-natural persons;".