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Case No: 7942/2008

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 02/11/2012

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in administration)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

AND UNDER THE INHERENT JURISDICTION OF THE COURT

Before:

MR JUSTICE BRIGGS

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Mr Iain Milligan QC, Mr David Blayney and Mr Daniel Bayfield (instructed by Linklaters LLP) for Lehman Brothers International (Europe)

Mr Martin Moore QC, Mr Nik Yeo
(instructed by Norton Rose LLP) for Lehman Brothers Inc.

Mr Richard Salter QC, Mr Jonathan Davies-Jones
(instructed by Field Fisher Waterhouse) for Lehman Brothers Finance AG

Mr Richard Snowden QC, Mr Ben Shaw
(instructed by Weil Gotshal & Manges LLP) for 314 Commonwealth Ave. Inc.

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Hearing dates: 27, 28 September, 1, 2, 3, 4 October 2012

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Approved Judgment

I direct that pursuant to CPR PD 39A para 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic.

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MR JUSTICE BRIGGS

Mr Justice Briggs :

Introduction

1. This application by the administrators of Lehman Brothers International (Europe) ("LBIE") seeks the court's directions as to the interpretation, characterisation, validity and present effect of what may loosely be described as security provisions in two standard form documents, originally devised for use as between LBIE and its external ("street") customers, but in this case used as between LBIE and an affiliated company within the Lehman Brothers group, namely Lehman Brothers Finance SA ("LBF"). Originally, similar issues were identified in relation to a third standard form agreement but, at a late stage in the preparation for the hearing of this matter, it became common ground that no transactions or activity ever occurred pursuant to it so that, although the resolution of those issues might have been of some theoretical use as guidance for the administrators in relation to similarly worded agreements with other parties, it was sensibly agreed at the outset of the hearing that it would be inappropriate for any further time or effort to be taken up in relation to it.

2. Notwithstanding that narrowing of the ambit of these proceedings, and late (but still welcome) agreement by the parties as to some specific issues, the issues which it is agreed that I should nonetheless still resolve exceed twenty, and some of those are significantly sub-divided.

3. Two unusual features appearing in both the documents lie at the heart of most, but by no means all, of the issues which I am invited to decide. The first is that, in each case, the documents purport to describe the security thereby created as a "general lien" with attendant rights of retention, sale and the application of proceeds, whereas in fact, as the parties would have known when the documents were created, the vast bulk of the property of LBF to which the security related, held from time to time by LBIE, consisted of intangibles, mainly de-materialised securities and money. The second is that, in addition to purporting to create security for payment of debts owed by LBF to LBIE, the same provisions purported also to constitute security in respect of debts owed by LBF to a broadly (if arguably imprecisely) defined class of LBIE's affiliates within the Lehman Brothers group but without, at least in express terms, creating any agency or trust relationship between LBIE and its affiliates regulating the circumstances in which LBIE might be obliged to realise the security for the benefit of its affiliates, or the priority as between LBIE and its affiliates in the application of any proceeds of such realisation. It is a reflection of the central importance of those two unusual features that this application has come to be known as the Extended Liens application.

4. In common with most of the previous applications by LBIE's administrators for directions, I have not on this occasion been required, or even invited, to decide any contentious issues of fact. For the most part, I have been invited to base my conclusions upon a statement of agreed facts, although for certain limited purposes I have been provided with assumed facts designed to operate, as previously, as a template by reference to which the administrators can deal with matters as they arise and when the precise facts are ascertained. The parties have indeed already identified further issues between them arising out of these two documents which I am specifically asked not to decide, because of their fact-sensitivity. Furthermore, it is

common ground that the agreed and assumed facts are to be taken as such only for the purposes of these proceedings.

5. The result is that this hearing has been concerned only with matters of law, and therefore with legal submissions. Nonetheless six full days of legal argument, preceded by the pre-reading of hundreds of pages of closely reasoned skeleton arguments, based on some eleven lever arch files of authorities, have been directed to the issues by four separate legal teams. Furthermore, the arguments have changed and developed substantially in relation to some of the main issues during the course of the hearing, despite the exchange of position papers between the parties designed (in lieu of statements of case) to assist in the identification of the real matters in dispute. The result was that important aspects of some parties' cases emerged for the first time only in reply, necessitating an unusual process of rejoinder speeches and a one day extension to the planned timetable for the hearing.

6. I make no complaint at all about those aspects of the manner in which the case has developed. On the contrary, the iterative process of position statements, skeleton arguments and, in particular, oral submissions has stimulated the analysis of these frequently complex issues, and their intricate relationship, at first instance in a manner which, it is to be hoped, may greatly reduce the risk of arguments being substantially re-cast, for the first time, at the appellate level. Beyond that, I wish to pay tribute to counsel (leading and junior) for the quality of the oral and written argument, and to the parties' solicitors for the helpful way in which the case has been prepared and presented generally.

THE PARTIES

LBIE

7. LBIE needs no introduction. It has been described in a number of previous decisions of mine, in terms which need not be repeated. It is sufficient for present purposes to say that LBIE was the European hub company within the Lehman Brothers group. It was, for that purpose, the main street-facing entity within the group for its European business, and the repository of such of the property of its street customers as was necessary or appropriate in connection with those customers' business transactions with group companies. Similarly it was a main repository for the property of its affiliates in connection with their activities in Europe.

   LBIE was represented at the hearing by Mr Iain Milligan QC, Mr David Blayney and Mr Daniel Bayfield.

LBF

8. Again, LBF will be reasonably familiar to most readers of this judgment. I need add little to my description of it in paragraphs 55 to 58 of my judgment in *Pearson & ors v Lehman Brothers Finance SA* [2010] EWHC 2914 (Ch) ("*RASCALS*"), save to say that LBF's Swiss bankruptcy process was recognised as a foreign main proceeding under the Cross-Border Insolvency Regulations 2006 ("CBIR") pursuant to the Order of Registrar Derrett on 12 November 2009.

9. LBF was joined to these proceedings first because it was LBIE's counterparty under both the documents with which I am concerned and, secondly, because it is the appropriate party to pursue all arguments tending to diminish the ambit, effect, validity and extent of the security rights purportedly created over LBF's property. In the jargon of these proceedings, it is the archetypal "ownership affiliate".

LBF was represented at the hearing by Mr Richard Salter QC and Mr Jonathan Davies-Jones.

314 Commonwealth Ave. Inc. ("314 CA")

10. 314 CA is a newcomer to the English litigation arising out of the Lehman group collapse. It is a Delaware company, having Lehman Brothers Holdings Inc. ("LBHI") as its ultimate parent company. As at September 2008, when the group collapsed, its primary function within the group was to act as a parent affiliate for a number of non-US affiliates that had been set up by the Lehman Brothers Strategic Transactions Group ("STG"), as well as being counterparty to various affiliates involved in the STG's transactions.

11. The reason for the joinder of 314 CA is that it is a creditor of one or more other group affiliates, but has no assets held by LBIE (and no other assets) capable of being encumbered by the security rights under review. Nonetheless, as a creditor of one or more affiliates (although not LBF) it is at least potentially a beneficiary of those security rights, to the extent that they are replicated in documents of the same type between LBIE and those affiliates which are its debtors.

12. 314 CA has therefore, after some period of searching, been identified and joined as a suitable proponent of all arguments favourable to the recognition and effect of that part of the security rights in issue which purport to appropriate relevant property as security for the payment of debts owed to affiliates other than LBIE.

314 CA was represented at the hearing by Mr Richard Snowden QC and Mr Ben Shaw.

Lehman Bros Inc. ("LBI")

13. Because of its importance within the group as a whole, and its status as the American hub company within the group, LBI has been a frequent participant in the litigation arising from the group's collapse. It signified, at an early stage, a desire to participate in this application, albeit an uncertainty as to whether its interests were better served by arguing for or against the effectiveness of purported extended liens. In the event, and at a late stage, LBI has aligned itself through the advocacy of Mr Martin Moore QC and Mr Nik Yeo with the ownership affiliate position of LBF although, for reasons which will become apparent, their participation in particular issues has differed in certain respects.

14. LBI is sufficiently described in paragraphs 61 to 63 of *RASCALS*. I should record at the outset that its primary case is that its relationship with LBIE is entirely governed by agreements falling outside the purview of this application, and that its participation

in these proceedings has, from start to finish, been subject and without prejudice to that contention. Whether that contention is well-founded is, by consent, not a matter for decision in these proceedings.

Outline of the Issues

15. I set out the complete agreed list of issues as headings in this judgment. It may however assist the reader to be provided at the outset with a bare outline. First, there are purely interpretative issues as to the security rights created by the two documents, the question being what, avoiding words of legal characterisation, are the parties' rights and obligations under each of them. Bearing in mind the express characterisation of the rights in terms of lien in the documents, the main question is whether they affect anything other than tangible property (including for that purpose certificated securities). There is an important question as to the precise extent of LBIE's rights of retention or withholding in relation to relevant property prior to default by LBF. Although not squarely raised as a distinct issue, it was originally central to the characterisation question whether the securities constituted fixed or floating charges. Although it is now common ground that, if charges at all, they were floating charges, the issue remains of importance in connection with the issue as to the qualification of the securities as security financial collateral arrangements under the Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) ("the FCARs").

16. Finally there is a fundamental question of interpretation, namely whether the apparent extension of the security rights so as to cover debts owed by LBF to LBIE's affiliates conferred rights on LBIE beneficially, or rights which LBIE was obliged to exercise as trustee or fiduciary both for itself and its affiliates. There is a separate question, arising (as the result of a late concession) only in relation to one of the two documents, whether affiliates have rights of enforcement of the security in respect of the debts owed to them, pursuant to the Contracts (Rights of Third Parties) Act 1999. Although in a sense that may be an issue as to extent and effect, it is because of the terms of section 1(2) of the Act primarily a question of contractual intent, and therefore of interpretation.

17. The second main area of contention concerns the appropriate legal characterisation of the security rights, once identified by interpretation: see per Lord Millett in *Agnew v Inland Revenue* [2001] 2 AC 710 at paragraph 32. It is sometimes said that there are only four types of consensual security right known to the law, namely pledge, lien, mortgage and charge. In this case the main candidates are lien and charge but, against the risk (to LBIE and 314CA) that, in relation to the overwhelmingly intangible relevant property, the rights are neither, it is argued in the alternative that they are a sui generis species which have the consequence of classifying the subject property as 'flawed assets', by analogy with the treatment of a charge-back in *Re Bank of Credit Commerce International SA* (*No 8*) [1996] Ch 245.

18. For the most part, the issues of legal characterisation are relevant because of the different statutory consequences applied to different categories of security right. In addition, characterisation may also be relevant as a stepping stone on the way to a conclusion whether the rights in issue are proprietary, or purely contractual.

19. It is as I have said common ground that, if the security rights are charges at all, they are floating charges. No one has advanced the argument that they merely create flawed assets in the hands of LBF as their primary case. It is advanced mainly as a fallback riposte to LBF's case that the purported grant of a security right to a grantee other than the grantor's creditor is conceptually incapable of being a charge, unless supported by a fiduciary obligation of the grantee to exercise it for the creditor's benefit.

20. Turning to validity and effect, much the biggest live issue in the proceedings (in terms of time and difficulty) is the question whether the security rights are saved from various forms of statutory invalidity (or postponement in priority) by virtue of the FCARs. The relevant forms of invalidity or postponement arise first from the fact that, if charges (and therefore by agreement floating charges) they were unregistered. This is not a consequence which LBF can pray in aid, but it is enthusiastically pursued by LBI. The second relevant invalidity arises under section 245 of the Insolvency Act 1986. It only affects the second of the documents under review (because the first was not made at a "relevant time" as defined). Similarly, invalidity for want of signature by the grantor under section 53(1)(c) of the Law of Property Act 1925 is again relied upon only in relation to the second of the two documents because the first was signed by LBF.

21. If those types of statutory invalidity are not in relation to these documents swept away by the FCARs, there are nonetheless additional issues as to the detailed application of section 245 and section 53, on the agreed and assumed facts.

22. Additional issues as to validity and effect arise from submissions that, properly interpreted and characterised, the security rights in relation to the affiliates' debts fall foul of the *British Eagle* principle, or of that part of the insolvency code dealing with set-off. There is finally a submission that, depending upon their proper characterisation, the security rights are invalidated by the regulatory regime relating to client money.

23. This outline seeks to identify the main issues in some logical order. In fact, the parties have by agreement enumerated the issues separately in relation to each of the two relevant documents, and have within that bifurcation also adopted an enumeration which departs to some extent, but by no means entirely, from what I conceive to be the relevant logical order. Nonetheless I intend to address the issues broadly in the order chosen by the parties and reflected in the agreed list of issues, beginning therefore with those relating to the first in time of the two documents, namely the Master Custody Agreement between LBIE and LBF dated as of 22 August 2003 (the "MCA").

The MCA

24. The MCA, in the form made between LBIE and LBF, was originally devised, as is implicit from its title and recitals, for the purpose of setting out the terms upon which LBIE would hold as custodian forms of property belonging to its customers (described in the agreement as clients). It was, in this form, drafted about two or three years previously, for use between LBIE and its street customers, so as to define the terms of a custody service provided to customers, either separately, or in conjunction with other business transacted by those customers with the Lehman Brothers group.

25. At the same time, by reason of its position as a hub company, LBIE provided custodial services in relation to the property of affiliates, including LBF. Prior to 2003, it is common ground that the terms upon which LBIE provided this service to its affiliates were undocumented. The need for documentation which led to the making of the MCA between LBIE and LBF arose from a requirement of the Taiwanese regulatory authorities, which required to be satisfied that the custodial relationship between LBIE and LBF was properly documented.

26. In *RASCALS*, at paragraphs 128 to 131, I had occasion briefly to consider the scope of the MCA as between LBIE and LBF. I concluded that it might have been of very limited effect in relation to the transactions there under review. The scope of the MCA (in the sense of the extent of the business between LBIE and LBF to which it related) is beyond the confines of this application. More generally, I noted at paragraphs 105 to 110 of *RASCALS* that the absence of any arm's length bargaining in the creation of Lehman group intercompany agreements, and the apparent dis-connect between their terms and the basis upon which, in practice, the intercompany business was carried out, together with the essentially regulatory purpose for which the agreements were made, left considerable uncertainty as to the extent to which agreements such as the MCA did accurately reflect the conduct of the existing relationship between those affiliates. Nonetheless I concluded that they could not be regarded as shams. I have been invited to approach the MCA in the present proceedings on the same basis.

27. The fact that the MCA was originally constructed for the purpose of regulating LBIE's custody service to its street customers leads in my judgment to the need to treat with some caution the ordinary rule that agreements are to be construed by reference to the matrix of mutually understood relevant facts arising simply between their parties. I consider it a fair starting assumption that, when deciding to use the MCA for a purpose internal to the group, LBIE and LBF may be supposed to have been content that its meaning and effect, as between LBIE and its existing street customers, would broadly be transposed to the internal relationship between LBIE and LBF, as if LBF was one of those customers, or rather a "client" within the meaning of the MCA.

28. The preamble to the MCA recites the wish of the client to open and maintain a custody account or accounts with the custodian (LBIE) to hold certain assets in accordance with the agreement. Clause 1 contains definitions of which the following are material:

> " '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.
>
> 'Securities' means bonds, debentures, notes, stocks, shares, units or other securities and all rights or property which may at any time accrue or be offered (whether by way of bonus, redemption, preference, option or otherwise) in respect of any of the foregoing or evidencing or representing any other rights or interests therein (including, without limitation, any of the foregoing not constituted, evidenced or represented by a certificate or other document but by an entry in the books or

> other permanent records of the issuer, a trustee or other fiduciary thereof or a Clearance System)."

29. It is common ground that, by the time when the MCA was drafted, the overwhelming bulk of the Property (as defined) held by LBIE for its street clients as custodian consisted of intangibles, mainly in the form of bank accounts and dematerialised securities. For some years prior to the making of the MCA between LBIE and LBF, virtually all the Property (as defined) held by LBIE for LBF had been intangible. There was no intention or perception that this would change.

30. Clause 2 provided for the appointment of LBIE by the client as custodian "to establish on the terms of this Agreement a custody account or accounts (the "Custody Account") in the name of the Client and in its capacity as Custodian, for the deposit of any Securities, Precious Metals and other Property from time to time received by the Custodian for the account of the Client together with any cash held or received in connection therewith".

By clause 3, the custodian agrees to accept for custody in the Custody Account at its discretion, Securities, Precious Metals and any other form of Property acceptable to the custodian and capable of deposit under the terms of the MCA.

31. Clauses 5 to 8 of the MCA contain detailed provisions as to LBIE's obligations as custodian, in relation to identification, segregation and accounting for Property held for its client as custodian. Clause 9, headed Withdrawal and Delivery, provided that:

> "The Client may, at any time subject to Section 13 hereof, demand withdrawal of all or any part of the Property in the Custody Account. Payments of cash shall be made at the expense of the Client by Banker's draft, telegraphic transfer, cheque or otherwise as may be agreed by the Custodian. Delivery of any Property other than cash will be made without undue delay at such locations as the Parties hereto may agree at the expense of the Client. Where necessary, the Custodian will on withdrawal transfer any Property into the name of the Client, or as it may direct at the expense of the Client. The Custodian 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."

32. Clause 13 lies at the centre of the Issues on this application. It is headed "Lien" and provides as follows:

> "The Client agrees that the Custodian shall have a general lien on all other 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 with any Person in the Lehman Brothers organisation. In the event of failure by the Client to discharge any of such liabilities and obligations when due, such non performance

> remaining un-remedied for a period of 3 days after notification by the Custodian to the Client the Custodian shall be entitled to sell, in a commercially reasonable manner after notice to the Client, or otherwise realise any such Property and to apply any moneys from time to time deposited with it under this Agreement and the proceeds of such sale or realisation in the satisfaction of such liabilities and obligations; for the purpose of such application the Custodian may purchase with any moneys standing to the credit of any account such other currencies and at such rate(s) of exchange as may be necessary to effect such application."

33. Clause 15 provides for either party to be at liberty to terminate the MCA on giving not less than 30 days' written notice to the other party following which, subject to clause 13, the custodian was to account to the client in accordance with the terms of clause 9. Clause 20 provided for the agreement to be governed by and construed in accordance with the laws of the country and state in which the custodian was located or performed its obligations. In the case of LBIE, that was England. It is common ground that, in addition to the obligations imposed by the MCA, LBIE was regulated in relation to its holding of clients' property and money as custodian by the Client Asset Rules ("CASS").

Issue 1: What is the nature of the Security Interest created by clause 13 of the LBF MCA and described as a "general lien"?

> **(a) is it a general lien and if so is it capable of applying to intangible property?**
>
> **(b) or is it properly characterised as a charge (which by its nature would bite on both tangible and intangible property)?**
>
> **(c) or is it to be characterised as some other form of security interest that is capable of applying to both tangible and intangible property?**

34. It was common ground between counsel that rights properly classified in English law as a general lien were incapable of application to anything other than tangibles and old-fashioned certificated securities. Bearing in mind the apparent desire of the draftsman of the MCA to confer upon the custodian a general lien over Property (as defined) consisting mainly or almost exclusively of intangibles, I invited the parties to consider whether the time might have come for English law to take a broader view of the matter, by analogy with the approach of the House of Lords in *Re BCCI No.8* [1998] AC 214, at 228 where, in relation to what had been previously been viewed by the Court of Appeal as the conceptual impossibility of a charge-back by customer to banker of an account in credit, Lord Hoffmann said this:

> "In a case where there is no threat to the consistency of the law or objection of public policy, I think that the courts should be very slow to declare a practice of the commercial community to be conceptually impossible. … the law is fashioned to suit the

> practicalities of life and legal concepts like 'proprietary interest' and 'charge' are no more than labels given to clusters of related and self-consistent rules of law."

Nonetheless, counsel continued to invite me to treat the established limitation of the scope of a general lien to intangibles as set in stone, or at least too firmly set to be disturbed at first instance.

35. For LBF Mr Salter submitted that the phrase "general lien" had a settled and unambiguous meaning to which effect had to be given, since to do otherwise would be to embark upon the impermissible course of re-writing the parties' bargain for them. For that purpose he referred me to the dictum of Lord Clarke in *Rainy Sky SA v Kookmin Bank* [2011] 1WLR 2900, at paragraph 23 that:

> "Where the parties have used unambiguous language, the court must apply it."

While acknowledging that the word "lien" may mean different things in different contexts, Mr Salter submitted that the phrase "general lien" was subject to no such ambiguity.

36. In my judgment the linguistic ambiguity in the present case lies not in the phrase "general lien", but in its juxtaposition with the phrase in clause 13 "on all other Property held by [*the custodian*] under the Agreement". It was, until a half-hearted attempt by Mr Salter to withdraw an earlier concession, common ground that the word "other" in the phrase "all other Property …" was incapable of being given any qualifying meaning, so that the relevant phrase read as a whole referred to a general lien on all Property held by the custodian under the MCA. Since the vast bulk of such Property is agreed to have been intangible, the ambiguity in the opening provision of clause 13 could not be stronger. The parties intended either to confer a general lien over an inconsequential residue, or to confer some other security right in relation to all the Property held in custody under the MCA.

37. Mr Milligan's submission for LBIE (supported by Mr Snowden for 314CA), was that "lien" was frequently used to connote what was in substance a charge since, for example, an equitable lien ordinarily takes effect by way of charge: see Snell's Equity (32nd Ed) at paragraph 44-004. Furthermore, he submitted that the sensible meaning to be given to the word "general" in the phrase "general lien" was that it was to be distinguished from a particular lien, so that the security interest conferred by clause 13 was not to be confined to property held in connection with the transaction giving rise to the relevant indebtedness. Mr Salter response was that the parties may have had a real intention to avoid creating a charge, at least until late in 2003 (when the FCARs came into force), due to the statutory requirement for registration, something which, he submitted, banks and similar institutions generally preferred to avoid.

38. In my judgment the answer to Issue 1(a) is that the MCA did not, either as between LBIE and its intended street clients, still less between LBIE and LBF, create a general lien in the strict sense. It seems to me highly improbable and therefore most unreasonable to attribute to commercial parties an intention to create security rights of a type incapable of applying to the overwhelming bulk of the property likely to be held as custodian by LBIE under its standard form MCA. Whether the phrase

"general lien" was intended to displace any risk that the security right might be specific rather than general, or merely a hangover from the days when most securities were in certificated rather than de-materialised form, I do not need to decide. It is obvious that the security right was not intended to be transaction specific, since it was expressed to extend over "all … Property" held under the MCA, and to constitute security for all liabilities and obligations of the client.

39. But that leaves for decision the question whether the rights can properly be characterised as a charge, or fall into some other and if so what residual category. For that purpose the court must first identify the rights conferred without recourse to legal characterisation, and then identify the appropriate characterisation thereafter.

40. The security rights conferred called for no wider examination of the MCA than clauses 13 and 9. Clause 13 appropriates all property held under the MCA for the satisfaction of the client's obligations. It confers an express power of sale upon the custodian and the right to apply both the proceeds of sale and any other monies held in the satisfaction of all such liabilities and obligations.

41. As between custodian and client (LBIE and LBF) such rights have all the typical attributes of a charge. That much was not seriously challenged. But as between the client and the custodian's affiliates, Mr Salter submitted that those rights were conceptually incapable of constituting a charge. He drew my attention to various classic definitions of a charge, which are couched in terms of conferring security for the payment of debts owed to the chargee. Examples may be found in *Palmer v Carey* [1926] AC 703 at 706, *Bristol Airport v Powdrill* [1990] Ch 744 at 760, *Fisher & Lightwood's Law of Mortgage* (13 Ed.) at para 1.17, and *Goode on Legal Problems of Credit and Security* (4th Ed.) at para 1.51, citing from Atkin LJ in *National Provincial & Union Bank of England v Charnley* [1924] KB 431, at 449.

42. Mr Salter realistically acknowledged however that there are as many definitions of the essential nature of a charge which do not in terms require that the creditor be its beneficiary, and that none of the definitions upon which he relied were coined specifically to deal with the question whether there can be a charge granted in favour of a person other than the creditor. Mr Salter also acknowledged (as he had to) both that his supposed conceptual limitation is asymmetrical, in the sense that it has never been a requirement that the grantor of a charge is the debtor, or even personally liable to pay the debt to which the charge relates, and that a valid charge may be granted to a trustee or other fiduciary of the creditor, as commonly occurs where property is charged to debenture trustees as security for debts owed to a class of investing creditors. But he submitted (and, as will appear later in this judgment, I agree) that there was no trust or fiduciary relationship between LBIE and its affiliates created in relation to the security rights purportedly conferred upon LBIE under the MCA.

43. In my judgment, it is not inherent in the nature of a charge that the chargee must be, or be a trustee or fiduciary for, the creditor. All that is necessary is that the chargee has a specifically enforceable right to have the relevant property appropriated to the payment or discharge of the relevant debt or other obligation. It is that right of specific enforcement which transforms what might have otherwise been a purely personal right into a species of proprietary interest in the charged property: see in particular the passage in *Palmer v Carey* referred to above where, giving the judgment of the Privy Council, Lord Wrenbury said this:

> "An agreement for valuable consideration that a fund shall be applied in a particular way may found an injunction to restrain its application in another way. But if there be nothing more, such a stipulation may not amount to an equitable assignment. It is necessary to find, further, that an obligation has been imposed in favour of the creditor to pay the debt out of the fund. This is but an instance of a familiar doctrine of equity that a contract for valuable consideration to transfer or charge a subject matter passes a beneficial interest by way of property in that subject matter if the contract is one of which a Court of equity will decree specific performance."

True it is that Lord Wrenbury naturally assumed (as is almost always the case) that the beneficiary of the right to specific performance was the creditor, but the thrust of his analysis is not aimed at that as a requirement. It is the right to specific performance that makes the critical difference.

44. That being so, I can see no good reason why A should not confer a specifically enforceable right on B to have A's property appropriated towards the discharge of a debt which A (or someone else) owes C, without any requirement that B be C's trustee or fiduciary. B may have good business or personal reasons to wish to ensure that A pays his debt to C, and I cannot see why the law should prevent B taking an enforceable (and therefore proprietary) interest in A's property so as to give himself the power to achieve that objective, without making himself a trustee or fiduciary for C. In truth, it seems to me that the relationship between B and C is irrelevant to the enforceability of A's promise to B, if it derives from a specifically enforceable contract between them.

45. In the context of the MCA and as I shall explain in more detail later in this judgment, I consider that there were eminently good business reasons why, in a standard form custody agreement designed for use with its street clients, LBIE should wish to obtain an enforceable right to have its client's property appropriated towards the discharge of its client's debts not merely to itself, but also to its Lehman group affiliates, without having to create any trust or fiduciary obligation in favour of those affiliates.

46. It follows that my answer to Issue 1(b) is that the Security Interest created by clause 13 of the MCA is properly characterised as a charge, both in relation to client debts to LBIE and client debts to LBIE's affiliates.

47. As for Issue 1(c), there may be rare cases in which security rights fall wholly outside the recognised categories of lien, pledge, mortgage or charge, and into a residual, purely contractual, category sometimes categorised as turning the grantor's property into a form of 'flawed asset'. This was the conclusion reached by the Court of Appeal in *Re BCCI* (*No 8*) [1996] Ch 245, in relation to the 'chargeback' rights which Millett J had decided were incapable of constituting a charge, in *Re Charge Card Services Ltd* [1987] Ch 150. The decision in *Re Charge Card Services Ltd* was disapproved by the House of Lords in *Re BCCI* (*No 8*) [1998] AC 214, but Lord Hoffmann appears to have been prepared to acknowledge that, had it been correct, the flawed asset analysis would have been acceptable: see page 225 F-G.

48. In the present case it was, or at least became, common ground that recourse should be had to a characterisation of the security interest created by clause 13 of the MCA in terms of flawed asset if, but only if, those rights could not properly be characterised as either a lien or a charge. Since I have concluded that they can properly be characterised as a charge, that concession makes it unnecessary for me to explore the flawed asset characterisation any further. I should add that the concession was in my judgement very properly made. The law (and in particular statute) routinely adopts established legal characterisation for the purpose of imposing constraints and regulatory controls of the creation and exercise of particular types of right. In relation to security rights, certain types of charges, including floating charges, are (or at least were until the coming into force of the FCARs) governed by a system of registration. That regime ought to be applied to all security rights capable of falling within the character of charges, and the law should not lightly enable the parties to avoid or evade a statutory regime, either by calling the security rights something different, or by any other means, if their essential nature brings them within that recognised category.

Issue 2: Are the rights in clause 13 to sell property and apply its proceeds and to apply 'monies from time to time deposited with [LBIE] under [the MCA]" part of the Security Interest created by clause 13 or are they free-standing contractual rights?

49. Mr Salter was the only proponent of the 'free-standing contractual rights' theory and, by the beginning of the hearing, he had limited his submission under Issue 2 to the right conferred on the custodian by clause 13 to apply monies deposited by the client towards the satisfaction of the relevant liabilities. He accepted that the power of sale, and the right to apply proceeds of sale, were properly to be regarded as part of the security interest created by clause 13, regardless whether that interest was a lien or charge. His submission that the right to apply monies deposited was a free-standing right had life in it only if, which I have rejected, the security interest operated by way of lien rather than charge. The free-standing contractual rights submission was the first plank in Mr Salter 's submissions (under later issues) that this right fell foul of the insolvency code as a right of set-off, or of the *British Eagle* principle as a provision for the disposition of an insolvent's property in its liquidation otherwise than in accordance with the insolvency code.

50. My conclusion that the security interest created by clause 13 of the MCA operates by way of charge leads inevitably to a conclusion that a right to apply deposited monies in satisfaction of the relevant liabilities is no more nor less than a charge over deposited monies, sufficient to create a proprietary interest in the money falling outside the client's property in its liquidation. As a result of *Re BCCI* (*No 8*), this would be so whether the phrase "deposited money" meant merely a personal right against LBIE (akin to that of a bank's customer), or the beneficial ownership of money deposited with LBIE as custodian and, pursuant to CASS, held in a segregated account. Since, on any view, clause 13 applies only to property (including money) deposited with LBIE 'under this Agreement', i.e. as a custodian, it is with the latter type of deposit that this case is mainly, if not exclusively, concerned.

51. Mindful of the likelihood that this case may be considered by a higher court, the parties have invited me to address issues not merely upon the basis of applying my conclusions about earlier issues, but upon the alternative basis that my earlier conclusions may turn out to be wrong. I intend to do so, but to express my reasons for

conclusions which assume that I have gone wrong at some earlier stage in the analysis only briefly. In the context of Issue 2, I need therefore to address the question whether if the security interest in clause 13 operates by way of lien, the right of application of money deposited is part of that security interest, or a free-standing contractual right.

52. In my judgment it would be a free-standing contractual right in relation to any intangible property not capable of being the subject matter of a lien. Money standing to the credit of an account is intangible. But there is in my view nonetheless no reason to treat the right to apply that money as a purely contractual right if, as I conclude, it has all the essential characteristics of a charge. Accordingly if I had reached the commercially unrealistic conclusion that the main part of clause 13 only affected a tiny part of the property held by LBIE as custodian, I would nonetheless have concluded that clause 13 created a charge over any deposited money, being a form of appropriation towards the satisfaction of debts capable of being specifically enforced.

Issue 3: If the answer to the first part of 1(a) or to 1(c) is yes, or if the answer to 2 is "free-standing contractual rights"

a) Is LBIE now prevented from enforcing the rights of sale and application contained in clause 13 by (i) the Insolvency Rules 1986 ("IR86") or (ii) the rule in British Eagle or (iii) CBIR Schedule 1 Art 20?

b) Have the rights of sale and application contained in clause 13 terminated automatically upon either of: (i) LBIE's administration; or (ii) a letter from LBF to LBIE dated 16 September 2008 terminating any authority LBIE had to act on LBF's behalf? (It is agreed that LBF's further argument that the rights of sale and application terminated automatically pursuant to Swiss law by virtue of LBF's insolvency lies beyond the scope of this application and is to be left over.)

c) If the answer to 3(b) is yes, is it thereby too late for LBIE to rely on those rights?

53. On my analysis thus far, Issue 3 does not strictly arise. Nonetheless, and at the parties' request, I will give my answers to these hypothetical questions, with brief reasons.

54. The question in Issue 3 (a) assumes that LBIE's rights of sale and application under clause 13 are either appurtenant to a lien or other form of non-proprietary security, or (which may be the same thing) free-standing contractual rights. The underlying theme is that, however understood, those rights do not form part of, or a means for the realisation of, a proprietary interest in the subject property falling outside LBF's insolvent estate. Nonetheless, the basis for an affirmative answer to question (3)(a)(i) was Mr Salter 's submission that, at least following the giving by LBIE's administrators of a notice of their intention to make a distribution under Rule 2.95 of the Insolvency Rules, all such contractual rights have been replaced by the statutory regime for insolvency set-off in Rule 2.85.

55. I confess that I have been quite unable, from start to finish, to understand this submission. Even if LBIE's rights of sale and application contained in clause 13 are treated as personal rather than proprietary, they are rights in relation to property held by LBIE as custodian for LBF and therefore, prima facie at least, on some form of trust, to which no set-off (whether arising under the general law or under the insolvency code) can apply: see paragraphs 325 to 336 of my judgment in the *Client Money* case, which were not the subject of any appeal. The rights are simply not what Rule 2.85(2) defines as "mutual dealings".

56. Mr Salter's second submission was that, on the assumption that they gave rise to no proprietary interest of LBIE in LBF's property, the security rights in clause 13 appeared to provide for an application of LBF's property in its insolvency different from that prescribed by the UK insolvency code, and therefore contrary to what is known as the *British Eagle* principle. Mr Snowden submitted that the *British Eagle* principle, being part of English insolvency law, could have no application to the insolvency of LBF unless and until there was any proposal that any part of LBF's property should be distributed, in its insolvency, in accordance with the UK insolvency code. He said the fact that LBF's Swiss insolvency had been recognised as a foreign main proceeding under the CBIR was irrelevant.

57. To this, Mr Salter responded that Mr Snowden's argument had been rejected on his (Mr Snowden's) own submission by Sir Andrew Morritt C in *Perpetual Trustee Co v BNY Corporate Trustee Services Ltd; Belmont Park Investments Pty Ltd v Corporate Trustee Services Ltd* [2009] EWHC 1912 (Ch) at paragraphs 47 to 48, in which the Chancellor described the argument as 'absurd' in the circumstances of that case.

58. In the *Belmont* case the defendant in the equivalent position to LBF in the present proceedings was Lehman Brothers Special Financing Inc. ("Lehman BSF") which was incorporated in Delaware, with a principal office in New York. Although the subject of a New York insolvency process, that process had not then been recognised as a foreign main proceeding under the CBIR. The relevant transactions were, as here, governed by English law. The Chancellor's main conclusion (and the ratio of the case) was that, even if it could be invoked by Lehman BSF, the *British Eagle* principle did not invalidate the relevant priority provisions. His conclusion that the absence of any English insolvency process affecting Lehman BSF did not exclude the *British Eagle* principle from consideration was clearly obiter and one upon which the Chancellor expressed only brief, albeit trenchant, views. Furthermore, although the particular principle in issue in that case was described by him as (and I think assumed at that stage by common consent to be) part of the *British Eagle* principle, it was later characterised in the Supreme Court in that case as a separate sub-rule, now generally known as the anti-deprivation principle, with which the *British Eagle* case was not, strictly, concerned.

59. While recognising what he called the "impeccable logic" of the argument that the *British Eagle* principle had no application in the absence of some insolvency process in England, the Chancellor's view was that, where the allegedly offending provision formed part of a contract governed by English law, it was sufficient for the applicability of the principle that the foreign company claiming the benefit of it could invoke the English insolvency code either by an application under the CBIR, or by commencing a separate English insolvency process, without any need for that actually to be undertaken, or any examination of the degree of likelihood that it would

lead to any distribution of assets in accordance with the English *pari passu* scheme of priorities.

60. I confess to having grave difficulty with that conclusion, if it is indeed what the Chancellor really meant (an interpretation which Mr Snowden vigorously contested). It would lead to the result that, where two foreign companies chose English law to regulate a transaction between them, they thereby incorporated the *British Eagle* principle as a rule which might invalidate some part of that transaction, however disconnected with England their businesses and transactions might be, and however remotely improbable it was that either of them would ever be subjected to an English insolvency process. The principle could, on Mr Salter 's submission, be relied upon even if the insolvency law of the places of incorporation or business of both of those companies contained quite different codes for the distribution of assets, and permitted derogation from that code in a manner which the *British Eagle* principle prohibits.

61. The invocation of the English courts' co-operation and assistance in connection with the insolvency of a foreign company does not, in any event, inevitably lead to the application of English insolvency law and remedies. Articles 21 to 23 of the UNCITRAL Model Law (incorporated into English law by Regulation 2 of the CBIR) make it clear that the grant of such relief is discretionary.

62. Beyond my expression of grave doubt as to whether the *British Eagle* principle applies automatically to all contracts governed by English law regardless of the propensity for the assets of any of the parties to be subjected to an English insolvency scheme of distribution, I do not propose to go further into these difficult and largely uncharted waters. The Chancellor's dicta on the point in the *Belmont* case were obiter and abbreviated, and my analysis of this issue in the present case is of a similar nature. The question deserves much more thorough argument and deeper consideration than has been possible or appropriate in the present proceedings, and I consider that no useful purpose would be served by my going any further into it. For present purposes it is sufficient for me to say, if the security rights conferred by clause 13 were, contrary to my view, of the purely personal nature which forms the assumed hypothesis which gives life to this issue, then I would not regard LBF as prohibited from seeking to invoke the *British Eagle* principle at some later stage, if it could persuade the English courts to embark upon, or provide relevant relief in connection with, some distribution of LBF's assets which the provisions of clause 13 would impede.

63. The final question under Issue 3(a) is whether LBIE's rights (if purely personal rather than proprietary) have been suspended by virtue of the recognition of LBF's Swiss insolvency as a foreign main proceeding under Article 20 of the UNCITRAL Model Law. Article 20 paragraph1(c) provides that upon recognition of a foreign proceeding that is a foreign main proceeding then subject to paragraph 2:

> "The right to transfer, encumber or otherwise dispose of any assets of the debtor is suspended."

Paragraph 2 makes it clear that this suspension shall be the same in scope and effect as if the corporate debtor had been made the subject of a winding-up order under the Insolvency Act 1986, and subject to the same powers of the court and the same

prohibitions, limitations, exceptions and conditions as would apply under the law of Great Britain in such a case.

64. It did not appear from the oral or written submissions of LBF's opponents that the applicability in those circumstances of Article 20 was in dispute, save that (which I believe also to be un-contentious) 314 CA pointed out that suspension under Article 20 did not of itself bring an end to any right of retention of LBF's property conferred by clause 13. Mr Snowden invited me to declare that, in any event, the court would permit the exercise of purely personal rights of sale and application of LBF's property pursuant to its jurisdiction under the Insolvency Act to do so. I do not regard that question as appropriate to be dealt with in the abstract, divorced from any specific application made to the court for that purpose.

65. Turning to Issue 3(b)(c), the underlying submission of Mr Salter for LBF was that any process of sale and application of LBF's assets (whether to discharge debts owed to it or its affiliates) unaccompanied by any proprietary interest in those assets would require LBIE to act as LBF's agent, and that any such agency was terminated by the onset of LBIE's administration, or by the express revocation of any agency in a letter from LBF to LBIE dated 16 September 2008. To LBIE's unsurprising response that any such agency was irrevocable since it was conferred for the advancement of LBIE's rather than LBF's interests, Mr Salter responded that, if the clause 13 rights were merely personal, the requisite agency was insufficiently coupled with any interest of LBIE for it to escape the general prohibition which the law places upon irrevocable agency. Mr Salter pursued the submission both in relation to the sale and application of LBF's property for the discharge of debts owed to LBIE and, but perhaps more vigorously, where those processes were employed for the discharge of LBF's debts to other Lehman affiliates. In such a case, so Mr Salter submitted, LBIE could have no interest of its own at all.

66. I consider LBF's arguments based upon the termination of any requisite agency to be misconceived. The true principle, clearly set out by Moore-Bick LJ in *Temple Legal Protection Ltd v QBE Insurance (Europe) Ltd* [2009] EWCA Civ 453 at paragraphs 49 to 50, is that the law leans against the recognition of irrevocable agency where, but only where, (as in most cases) the agency is fiduciary. In such a case the agent's authority to act for his principal depends upon the continued existence of a relationship of trust and confidence between them, the destruction of which must enable the agency to be terminated.

67. Here by contrast, the rights of sale and application of LBF's property in clause 13, even if purely personal, are granted to LBIE by way of security and, to the extent that their exercise involves some form of agency by LBIE for LBF, that agency is not in the relevant sense fiduciary (i.e. exercisable for the benefit of LBF). It is granted purely for the better enforcement of those security rights against LBF's property and, as a matter of necessary implication, persists for as long as those security rights are available to be enforced.

68. Furthermore, it is in my view a fallacy to suggest that where LBIE enforces those rights for the purpose of the discharge of LBF's debts to other affiliates, it is not acting in its (rather than LBF's) interests. For reasons which I will explain in due course, LBIE's exploitation of those rights is, for as long as the group remained a going concern, prima facie in the interests of its stakeholders (namely LBHI, the

ultimate parent of all companies within the Lehman group). Following the radical change in the identity of LBIE's stakeholders brought about by its insolvency, those rights will now be exploited strictly to the extent that LBIE's unsecured creditors are capable of being benefited thereby. In either case LBIE is acting in its interests in realising the security, rather than as a fiduciary for LBF.

69. The answer therefore to Issue 3(b)(c) is that, even if purely personal, the rights of sale and application conferred by clause 13 have not been terminated either by LBIE's administration or the letter dated 16 September 2008, so that it would not be too late now for LBIE to rely upon them.

Issue 4: If the answer to 1(b) is yes:

a) Is the charge fixed or floating? In answering this question, the following sub-issues arise: (i) Is it necessary for this purpose for LBIE to have exercised actual control over the Assets subject to the charge? (ii) If so, was the control actually exercised by LBIE sufficient for this purpose?

b) Is it a charge in respect of LBF's liabilities to LBIE only?

c) If it could otherwise be a charge in respect of LBF's liabilities to other "Lehman Brothers entities", have the rights of sale and application in clause 13 in respect of such liabilities been terminated by virtue of any of the matters referred to in 3(b) and, if so, is it too late for LBIE to exercise those rights? (It is agreed that LBF's further argument that the rights of sale and application terminated automatically pursuant to Swiss law by virtue of LBF's insolvency lies beyond the scope of this application and is to be left over.)

70. I can deal with the whole of this issue relatively briefly. I have already concluded that the answer to Issue 1(b) is yes. On the eve of the hearing of this matter, counsel for LBIE conceded that any charge created by clause 13 of the MCA was a floating charge. That concession had already been made in the skeleton argument served on behalf of 314 CA. The concession was made by LBIE on the narrow basis that, when read in conjunction with the last sentence of clause 9 of the MCA, the terms of the clause 13 charge clearly permitted LBF a right to substitute or withdraw excess property from the ambit of the charge (pending crystallisation) so that, pursuant to the analysis of the House of Lords in *National Westminster Bank plc v Spectrum Plus Ltd* [2005] 2 AC 680, it could not be a fixed charge. That concession makes it unnecessary at this stage for me to conduct a close examination of the extent of the parties' legal or administrative control over the property subjected to the clause 13 charge, although it will be necessary to return to that question in some detail when addressing the issues as to the applicability of the FCARs.

71. The question in Issue 4(b) was a further platform for the advancing by LBF of the submission that a charge to secure debts owed to someone other than the chargee, in the absence of a trust relationship, was a conceptual impossibility. I have rejected that argument under Issue 1 and need say no more about it.

72. Issue 4(c) is, again, a platform for the pursuit of an aspect of the argument which I have rejected under Issue 3(b) above. It follows that Issue 4 may be answered as follows:

a) The clause 13 charge is a floating charge.

b) It is a charge in respect of LBF's liabilities both to LBIE and to its affiliates.

c) The rights of sale and application in clause 13, being rights incident to that charge, have not been terminated either by LBIE's administration or by the letter from LBF to LBIE dated 16 September 2008, so that it is not too late for LBIE now to exercise them.

Issue 5: Charge on book debts

73. The concession that the clause 13 charge was a floating charge makes it unnecessary to consider, in addition, whether it was a charge of LBF's book debts. It is agreed that I need say nothing about this issue.

Issue 6: Is the Security interest created by clause 13 saved by the Financial Collateral Arrangements (No 2) Regulations 2003 ("FCAR") from any of the forms of invalidity or challenge that are excluded thereby? In answering this question the following sub-issues arise:

a) Do the FCAR apply in relation to any Security interests created by agreements entered into before 26 December 2003?

b) **Did the charges constitute a "security financial collateral arrangement" for the purposes of FCAR? In answering this question, the following sub-issues arise:**

i) Does the arrangement (to the extent of the Security Interest in respect of the debtor-affiliate's liabilities to other Lehman Brothers entitles) fall outside the scope of limb (a) of the definition of "security financial collateral arrangement" in Regulation 3 because of the "multilateral" rather than "bilateral" nature of the arrangement?

ii) What, in the context of limb (a), is the "agreement or arrangement" in relation to the Security interest created by clause 13 and is its purpose other than to secure relevant financial obligations owed to the collateral taker?

iii) Did LBIE, or a person acting on its behalf, have the requisite possession of, or control over, the Assets so that the test contained in limb (c) of the definition of "security financial collateral arrangement" in Regulation 3 is satisfied?

74. The questions arising in relation to the FCARs eventually came to dominate the hearing of these proceedings. The extraordinary thoroughness with which the *travaux*

preparatoires surrounding the underlying Directive (2002/47/EC) were deployed was the product of the burning of much midnight oil by counsel, and led to the development by LBIE of an altogether new case in its reply submissions (unheralded in a skeleton argument) which in turn led to the need for substantial submissions in rejoinder, in particular by Mr Salter for LBF.

75. Issue 6(a) arises in relation to the MCA because it was entered into in August 2003, a little over four months before the FCARs came into force on 26 December 2003. Issue 6(b) arises because it is alleged (by LBF and LBI) that the floating charge created by clause 13 of the MCA fell foul of three aspects of the definition of "security financial collateral arrangement" in Regulation 3 of the FCARs, tests which may be summarised as "bi-laterality", "purpose" and "possession or control". Since the questions arising under Issue 6(b) go to the heart of the meaning and intent of the FCARs regime, I intend to take the two sub-issues under Issue 6 in reverse order.

76. Issue 6(b) is mainly concerned with questions of interpretation of the FCARs, although there are subsidiary questions as to their application, once correctly interpreted, to the floating charge created by the MCA. As national legislation implementing an EU directive, the FCARs are to be interpreted, so far as possible, in a manner consistent with the meaning and purpose of the directive. At paragraphs 56 to 58 of my judgment in the *Client Money* case, I set out a summary of the relevant principles applicable to that process of interpretation. Counsel in the present case invited me to adopt it for present purposes, and I shall do so without repeating it.

77. The relevant directive is the Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements. I shall refer to it as "the Directive". It is convenient to begin with a description of the purpose of the Directive, by reference mainly to its recitals. The following are material for present purposes:

> "(1) Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems constituted a milestone in establishing a sound legal framework for payment and securities settlement systems. Implementation of that Directive has demonstrated the importance of limiting systemic risk inherent in such systems stemming from the different influence of several jurisdictions and the benefits of common rules in relation to collateral constituted to such systems.
>
> (3) A Community regime should be created for the provision of securities and cash as collateral under both security interest and title transfer structures including repurchase agreements (repos). This will contribute to the integration and cost-efficiency of the financial market as well as to the stability of the financial system in the Community, thereby supporting the freedom to provide services and the free movement of capital in the single market in financial services. This Directive focuses on bilateral financial collateral arrangements.

(5) In order to improve the legal certainty of financial collateral arrangements, Member States should ensure that certain provisions of insolvency law do not apply to such arrangements, in particular, those that would inhibit the effective realisation of financial collateral or cast doubt on the validity of current techniques such as bilateral close-out netting, the provision of additional collateral in the form of top-up collateral and substitution of collateral.

(9) In order to limit the administrative burdens for parties using financial collateral under the scope of this Directive, the only perfection requirement which national law may impose in respect of financial collateral should be that 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 of a person acting on the collateral taker's behalf while not excluding collateral techniques where the collateral provider is allowed to substitute collateral or to withdraw excess collateral.

(10) For the same reasons, the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement, or the provision of financial collateral under a financial collateral arrangement, should not be made dependent on the performance of any formal act such as the execution of any document in a specific form or in a particular manner, the making of any filing with an official or public body or registration in a public register, advertisement in a newspaper or journal, in an official register or publication or in any other matter, notification to a public officer or the provision of evidence in a particular form as to the date of execution of a document or instrument, the amount of the relevant financial obligations or any other matter. This Directive must however provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding *inter alia* the risk of fraud. This balance should be achieved through the scope of this Directive covering only those financial collateral arrangements which provide for some form of dispossession, i.e. the provision of the financial collateral, and where the provision of the financial collateral can be evidenced in writing or in a durable medium, ensuring thereby the traceability of that collateral. For the purpose of this Directive, acts required under the law of a Member

> State as conditions for transferring or creating a security interest on financial instruments, other than book entry securities, such as endorsement in the case of instruments to order, or recording on the issuer's register in the case of registered instruments, should not be considered as formal acts.
>
> (11) Moreover, this Directive should protect only financial collateral arrangements which can be evidenced. Such evidence can be given in writing or in any other legally enforceable manner provided by the law which is applicable to the financial collateral arrangement.
>
> (12) The simplification of the use of financial collateral through the limitation of administrative burdens promotes the efficiency of the cross-border operations of the European Central Bank and the national central banks of Member States participating in the economic and monetary union, necessary for the implementation of the common monetary policy. Furthermore, the provision of limited protection of financial collateral arrangements from some rules of insolvency law in addition supports the wider aspect of the common monetary policy, where the participants in the money market balance the overall amount of liquidity in the market among themselves, by cross-border transactions backed by collateral.
>
> (17) This Directive provides for rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects in case of a default of a party to a financial collateral arrangement. However, this Directive balances the latter objectives with the protection of the collateral provider and third parties by explicitly confirming the possibility for Member States to keep or introduce in their national legislation an *a posteriori* control which the Courts can exercise in relation to the realisation or valuation of financial collateral and the calculation of the relevant financial obligations. Such control should allow for the judicial authorities to verify that the realisation or valuation has been conducted in a commercially reasonable manner."

78. In summary, the Directive was designed to build upon the success of the Directive 98/26/EC on settlement finality in payment and securities settlement systems (Recital 1) by focusing on a new community-wide regime for "bilateral financial collateral arrangements" (Recital 3). It was to do so by providing a common regime of

minimum formalities for the creation of qualifying arrangements, free from the particular (and inevitably differing) formality regimes applicable under the different laws of Member States (Recitals 9, 10 and 11). Qualifying arrangements should be capable of rapid and non-formalistic enforcement (Recital 17) and freed from the restrictive provisions of national insolvency legislation (Recitals 5 and 10). But the need to balance the protection of the contracting parties, and third parties, from the risk of fraud meant that the new regime should extend only to financial collateral arrangements which provide for some form of dispossession of the grantor in relation to the property provided as collateral: see Recital 10.

79. For the achievement of those objectives, the Directive sought to define a qualifying collateral arrangement (so far as is material for present purposes) in the following provisions of Article 2, headed Definitions.

> "1. For the purpose of this Directive:
>
> a) 'financial collateral arrangement' means a title transfer financial collateral arrangement or a security financial collateral arrangement whether or not these are covered by a master agreement or general terms and conditions;
>
> b) 'title transfer financial collateral arrangement' means an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations;
>
> c) 'security financial collateral arrangement' means an arrangement under which a collateral provider provides financial collateral by way of security in favour of, or to, a collateral taker, and where the full ownership of the financial collateral remains with the collateral provider when the security right is established; "

80. A further restriction appears in Article 1.5 as follows:

> "This Directive applies to financial collateral once it has been provided and if that provision can be evidenced in writing.
>
> The evidencing of the provision of financial collateral must allow for the identification of the financial collateral to which it applies. For this purpose, it is sufficient to prove that the book entry securities collateral has been credited to, or forms a credit in, the relevant account and that the cash collateral has been credited to, or forms a credit in, a designated account.
>
> This Directive applies to financial collateral arrangements if that arrangement can be evidenced in writing or in a legally equivalent manner. "

'Provision' is defined in Article 2.2 as follows:

> "References in this Directive to financial collateral being 'provided', or to the 'provision' of financial collateral, are to the financial collateral being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf. Any right of substitution or to withdraw excess financial collateral in favour of the collateral provider shall not prejudice the financial collateral having been provided to the collateral taker as mentioned in this Directive."

81. Before addressing the Regulations, the following points may be noted about the structure of those operative provisions of the Directive. First, there is no reference in those provisions to a requirement that the qualifying arrangement should be "bi-lateral". Bi-laterality is a concept which is, at least in express terms, confined to the recitals, notably Recitals 3 and 5 (and also 14, although it is unnecessary to set it out, because it refers to "bi-lateral close-out netting" rather than to bi-lateral arrangements).

82. Secondly, and consistently with Recital 3, Article 2.1 separates out two types of financial collateral arrangement, namely "title transfer" and "security". Thirdly, Article 2.1 applies a purpose test only to a title transfer financial collateral arrangement, and not to a security financial collateral arrangement. Finally, the possession or control concept set out in Article 2.2 is applied to financial collateral arrangements by reference to the requirement that they be "provided" (in Article 1.5), although in Article 2.1 the requirement for provision appears expressly only in relation to security rather than title transfer forms of financial collateral arrangement, it being perhaps implicit that the transfer of full ownership of financial collateral under a title transfer financial collateral arrangement is a form of provision sufficient to satisfy the requirement that there be a sufficient dispossession of the provider highlighted in Recital 10.

83. The FCARs constituted HM Treasury's first attempt to implement the Directive in the context of British law. I say 'first', because, in 2010, after the period relevant for present purposes, amendments were formulated which, in one critical respect, represented an advance in the Treasury's thinking about the meaning of the Directive. Nonetheless it is the FCARs in their original form which is material for present purposes. In Regulation 3, headed Interpretation, there appear the following relevant definitions:

> "financial collateral arrangement" means a title transfer financial collateral arrangement or a security financial collateral arrangement, whether or not these are covered by a master agreement or general terms and conditions;
>
> "security financial collateral arrangement" means 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;

"security interest" means any legal or equitable interest or any right in security, other than a title transfer financial collateral arrangement, created or otherwise arising by way of security including –

…

(d) a charge created as a floating charge where the financial collateral charged 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; or

(e) a lien;"

For completeness I should note that the definition of "title transfer financial collateral arrangement" includes (inter alia) the same purpose test as in sub-paragraph (a) of the definition of security financial collateral arrangement, and is required also to be made between non-natural persons. There is however no equivalent in that definition to the possession or control requirement in paragraph (c) of the definition of security financial collateral arrangement, or paragraph (d) of the definition of security interest.

84. Regulation 4 dis-applies both section 53(1)(c) of the Law of Property Act 1925 and section 395 of the Companies Act 1985 in relation to financial collateral

arrangements. Regulation 10(5) dis-applies section 245 of the Insolvency Act 1986 to any charge created or otherwise arising under a security financial collateral arrangement.

Bi-laterality

85. Mr Salter, supported by Mr Moore for LBI, submitted that the security created by clause 13 failed to qualify as a security financial collateral arrangement because it was multi-lateral in the sense that it created a security for the debts of LBIE's affiliates, rather than for LBIE alone. Strictly speaking, LBF did not engage with the FCARs issues in relation to the MCA, because its liquidator and creditors enjoy no benefit from the registration provisions of section 395 and following, nor from section 53 of the Law of Property Act because the MCA was signed on LBF's behalf, nor from section 245 because the floating charge was not made at a relevant time. Nonetheless, as will appear, LBF ran its full case about the non-applicability of the FCARs in relation to the STB and, as between it and LBI, undertook the main burden of the submissions in that regard, with Mr Moore for LBI taking a supporting role, save in relation to the retro-activity issue. It was therefore, strictly, Mr Moore's case about bi-laterality with which I have to deal in relation to the MCA, but since Mr Salter bore the brunt of the argument (which was virtually the same in relation to both agreements), I shall refer to it for convenience as his.

86. I consider that the bi-laterality argument advanced by LBF and LBI is wrong on two counts. First, there is in my view no "bi-laterality test" imposed by the Directive or by the Regulations. Secondly, even if there is, it is satisfied in relation to the MCA because it was in the relevant sense a bi-lateral arrangement conferring no proprietary interest upon, or rights directly enforceable by, anyone other than its two parties.

87. I accept the submission of Mr Snowden, supported by Mr Milligan, that the reference in Recital (3) of the Directive to "bi-lateral financial collateral arrangements" is made simply by way of distinction from the subject matter of the earlier directive 98/26/EC on settlement finality in payment and securities settlement systems. It was not intended to confine the scope of the Directive to agreements between only two parties. The reference in Recital (5) to bi-lateral close-out netting" is in no sense definitive of the scope of the Directive as a whole, and there is nothing whatsoever in the operative provisions of the Directive to justify any such limitation of its scope. In that respect, the Regulations march hand in hand with the Directive.

88. I also accept Mr Snowden's and Mr Milligan's submission that it would be absurd to treat the Directive as strictly confined to two party arrangements because it would exclude from its scope security financial collateral arrangements made between the security provider and a debenture trustee for a class of investors unless such arrangements were treated as bi-lateral in the same way as I regard the MCA to be bi-lateral. I can think of no conceivable reason why the framers of the Directive should have wished to exclude such an important type of financial collateral arrangement from its scope and, in my judgment, bi-laterality is not a relevant condition of the identification of a qualifying financial collateral arrangement.

89. The reasons for my conclusion that the MCA is in any event bi-lateral in every relevant sense are more fully set out later, in relation to the question whether there is to be implied some trust of the clause 13 security rights by LBIE in favour of its

Lehman group affiliates. Nonetheless, even if I had concluded that such a trust or other fiduciary obligation was to be implied, so that some sort of enforceable rights were conferred on affiliates, they would be likely to be rights as against LBIE rather than directly against LBF, and would not disturb the essential bi-laterality of the arrangement as between LBIE and LBF. Accordingly, the answer to Issue 6(b)(i) is that the arrangement constituted by the MCA does not fall outside the definition of security financial collateral arrangement by reason of any multi-lateral rather than bi-lateral aspect of it.

Purpose

90. It is undeniable that, in sharp contrast with Article 2.1(c) of the Directive, the definition of security financial collateral arrangement in Regulation 3 appears at sub-paragraph (a) to impose a form of purpose test. Furthermore, it does so by reference to the securing of financial obligations owed to the collateral-taker, rather than to third parties. In that respect, it appears to impose a stricter test than the purpose test which does appear in Article 2.1(b) of the Directive, where it is related to the definition of a title transfer financial collateral arrangement. There, the purpose is only the securing or "otherwise covering the performance" of "relevant financial obligations". That phrase is itself defined in Article 2.1(f) in a manner which does not confine them to obligations owed to the collateral taker although, at sub-paragraph (ii), those are unsurprisingly included.

91. Read literally therefore, the Regulations appear to confine the scope of the Directive within the UK in two significant respects. First, they appear to superimpose a separate purpose test in relation to what would otherwise qualify as a security financial collateral arrangement. Secondly, they do so by focusing that test upon a narrower range of relevant financial obligations as the subject matter of the security than does the Directive, namely only upon obligations owed to the collateral taker.

92. It is common ground that this Directive is a minimum harmonisation directive: see Recital (22). It is therefore the obligation of each Member State to implement it by domestic legislation in a manner that is at least as broad as the original scope of the Directive, although Member States may go further. In the present case the UK went substantially further than the Directive in one important respect, namely by extending the scope of the regime to arrangements between any non-natural persons (see sub-paragraph (d) of the definition of security financial collateral arrangement) whereas the Directive was designed to create a regime limited to a much more restricted class of public authorities, central banks and financial institutions: see Article 1.2. But the gold-plating of a system for the implementation of a minimum harmonisation directive in one respect does not justify derogation from it in another. Accordingly, it is for the national court to construe the domestic legislation (here the Regulations) as far as possible in a manner which does not derogate from the intended scope of the Directive, once that scope has been accurately identified as a matter of construction of the Directive.

93. It is perfectly understandable that the Directive should have imposed a purpose test within the definition of title transfer financial collateral arrangement. This is because the scheme of the Directive was plainly intended to be limited to the provision of securities (see Recital 3), whereas forms of title transfer arrangements such as repos and stock loans are commonly used for purposes other than the provision of security.

94. By contrast it is much less clear why either the Directive or the Regulations should have included a similar purpose test in relation to security financial collateral arrangements since, both under the Directive and Regulations, the definition is confined to arrangements which in fact create a security interest in financial capital for securing relevant obligations. The Directive does indeed impose no such additional test, and it might reasonably have been regarded as mere surplusage for it to have done so. The question therefore arises why, in implementing the Directive within the context of English law, the draftsman of the Regulations should have imposed this apparently unnecessary additional test. It was submitted to me that it was a simple drafting mistake, arising from the unthinking transposition of the purpose test needed for title transfer financial collateral arrangements into the largely parallel definition of security financial collateral arrangements. It was submitted that, in any event, an arrangement by which (pursuant to sub-paragraph (b)) there did in fact arise a security interest in financial collateral to secure obligations would automatically satisfy the purpose test in sub-paragraph (a) without further examination.

95. While it may be that, consistent with the approach to transactional documents in the *ICS* case, the court may as part of the process of interpretation of implementing regulations simply conclude that there has been a mistake, I prefer to conclude that the introduction of a separate purpose test may derive from the propensity of English law to identify security interests as created by operation of law rather than merely by express contract. Where there is an express contract for the creation of a security, the purpose test is thus automatically satisfied. Where the security arises by operation of law, the Regulations impose the additional requirement that the arrangement in question was intended to create a security interest.

96. By contrast, Mr Salter and Mr Moore submitted that the purpose test in the Regulations was designed to confine the regime to those arrangements which had the provision of security as a predominant or significant (or at least more than incidental) purpose, rather than as a mere incident in a transaction designed primarily for some different purpose. Thus in relation to the MCA they submitted that, taken as a whole, its predominant purpose was the regulation of the terms upon which property was provided to LBIE as custodian, and that the security created by clause 13 was, in particular as between LBIE and LBF, *de minimis* in terms of purpose. Finally they submitted that, in any event, the attempt to secure financial obligations owed to LBIE's affiliates took clause 13 clearly outside the restricted scope of the purpose test in sub-paragraph (a) of the definition.

97. I have not been persuaded by any of those submissions. First, it is evident from the definition of "financial collateral arrangement" in Regulation 3 that the "arrangement" may appear within a master agreement or general terms and conditions, so that the identification of the arrangement with the whole of the MCA which lies at the heart of these submissions is inconsistent with the scheme of the Regulations. For present purposes, the relevant "arrangement" is not the MCA as a whole, but the security created by clause 13.

98. I was briefly a little more impressed by the narrower argument that the purpose test was designed to focus upon the purpose for which the financial collateral was provided, rather than the purpose of the arrangement viewed in the round. There is some force in the notion that property provided by LBF to LBIE under the MCA is

provided predominantly for the purpose of its being held in custody, rather than as security for the relevant debts owed to LBIE and its affiliates. Nonetheless I have concluded that this argument should also be rejected. It is inconsistent with the language of the definition in Regulation 3, which refers to the purpose of the agreement or arrangement rather than the purpose of the provision of the collateral. It would also introduce an unsatisfactory requirement for the subjective investigation of the parties' motivation into what is meant to be a scheme encouraging the reliable creation of security with minimum formality and minimum risk of uncertainty or unenforceability: see Recitals (3) (9) (10) and (17).

99. I have been a little more troubled with the apparent limitation of sub-paragraph (a) of the definition of security financial collateral arrangement in Regulation 3 to securities given for obligations owed to the collateral taker. If literally applied it would, again, appear to exclude security given to a debenture trustee for debts owed by the collateral giver to a class of investors, where the collateral taker would not to any significant extent be likely to be a creditor at all. Furthermore, it is, as I have described, clearly at variance with the much broader definition of "relevant financial obligations" in Article 2.1(f) of the Directive. I have in the end been driven to the conclusion that this part of sub-paragraph (a) should be treated as descriptive rather than restrictive, in much the same way as the classic English definitions of a charge unthinkingly (rather than by way of limitation) assume that the property is security for a debt owed to the chargee.

100. The MCA plainly creates security over LBF's relevant property for the purpose of securing debts owed by LBF to LBIE and, to that extent, qualifies as a security financial collateral arrangement. In my judgment it would be contrary to the Directive for the regime to be disapplied to clause 13 of the MCA merely because it constituted security for debts owed to LBIE's affiliates. Accordingly, whatever may have been the reason for that apparent restriction in sub-paragraph (a) of the definition in Regulation 3, it should not be construed as excluding the security created by clause 13 for that reason. Accordingly, the answer to the question in Issue 6(b)(ii) is that the relevant "agreement or arrangement" is that part of the MCA creating the security over LBF's property. Its purpose is to secure relevant financial obligations. It is not disabled from qualification as a security financial collateral arrangement by reason of the fact that it also secures relevant financial obligations owed to LBIE's affiliates.

Possession or control

101. Both the Directive and Regulations make it a condition for the applicability of the regime that the financial collateral be "delivered, transferred, held or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf". This is, in the Regulations, part of the definition of security financial collateral arrangement: see sub-paragraph (c). In the Directive it is incorporated into the definition by the requirement in Article 2.1(c) that the collateral be provided, and the definition of "provided" or "provision of financial collateral" in Article 2.2. In both cases it is stated that the existence of rights of substitution or the withdrawal of excess collateral do not detract (in the Regulations) from possession or control and (in the Directive) from the requisite "provision". There is a slight difference between the two formulations of the substitution and withdrawal exception, in that the Directive refers generally to rights of substitution, whereas the Regulations refer to a narrower right "to substitute

equivalent financial collateral". It appears overwhelmingly likely that the inclusion of the word "equivalent", as part of a precisely defined phrase in Regulation 3 was a mistake since, without any intermediate amendment of the Directive, HM Treasury removed it from sub-paragraph (c) of the definition of security financial collateral arrangement by amendment of the Regulations in 2010. Nothing of significance turns on the fact that this amendment had not been made at the material time for the purposes of these proceedings.

102. In the present case, there emerged in the course of argument a fundamental division of view as to the interpretation of the possession or control requirement. For LBF and LBI it was argued that the requirement to demonstrate possession or control was superimposed as an additional condition upon the requirement that the collateral be "delivered, transferred, held, registered or otherwise designated", and called for an examination of the terms upon which that delivery, transfer, holding, registration or designation had occurred of much the same type as is conducted by the English court when seeking to distinguish between a fixed and a floating charge. In short, it was said that if the collateral provider retained dominion over the collateral, in the sense of having the right, pending crystallisation, to direct how it should be dealt with, then neither possession nor control could be demonstrated in favour of the collateral taker, so that the arrangement failed to qualify under the FCARs. Consistently with the analysis of fixed and floating charges in the *Spectrum Plus* case, it was submitted that this test required an examination both of the parties' respective legal rights, and of the question whether those rights were exercised in practice.

103. For LIBE and 314 CA it was submitted that the phrase "so as to be in the possession or under the control of the collateral-taker…." merely described the consequence of any delivery, transfer, holding, registration or designation, and added no further condition or requirement. The purpose both of Article 2.2 and sub-paragraph (c) of the definition of security financial collateral arrangement in Regulation 3 was simply to separate out collateral held as security by the taker from collateral subjected to some form of security interest while remaining held by the collateral provider, without any transfer, delivery, registration or otherwise designation to or in the collateral-taker's name.

104. This fundamental distinction was contested with the utmost tenacity and detail by all four parties to this application, for which purpose I was taken to extensive extracts from the *travaux preparatoires* underlying the Directive, to the only English decision on the question, to numerous learned commentaries, and to a report of the Financial Markets Law Committee concentrating on this issue.

105. It is convenient to begin with a chronological description of the manner in which the possession or control concept was introduced into the Directive, and the subsequent analysis of its meaning and effect, both in this court and in learned commentaries. It is common ground that the phrase "possession or control" both in the Directive and in the Regulations must be given an independent meaning rather than one derived from the meanings normally attributed to those words in English law.

106. The form in which the Directive was originally proposed by the Commission in March 2001 (in the form of a draft directive supported by an Explanatory Memorandum) made no reference to possession or control at all. The definition of

security financial collateral arrangement in Article 3.1(c) of the draft Directive was that it:

> "Means an arrangement under which a collateral provider disposes of, or delivers financial collateral by way of security in favour of, or to, a collateral taker, for the purpose of securing the performance of relevant financial obligations, where ownership of the financial collateral remains with the collateral provider unless and until the financial collateral is transferred or appropriated to the collateral taker or transferred to a third party as a result of … the exercise of various rights."

Nor was there any definition of "provision" which included any possession or control requirement.

107. The Recitals to the draft Directive also excluded any reference to the need to strike a balance between, on the one hand, market efficiency and, on the other, the safety of the parties to the arrangement and third parties, thereby avoiding the risk of fraud now to be found in Recital 10, or to the requirement for dispossession as the key to the appropriate striking of that balance.

108. In its commentary on the proposed Article 4 (which disapplied national law formalities such as registration) the Explanatory Memorandum stated:

> "The Directive is not intended to interfere with the laws or regulations of Member States as regards publicity and registration, except to the extent that the penalties for breach of such a law or regulation include the invalidity of a financial collateral arrangement. The reason why such a sanction should not be imposed is that the Directive applies to a financial collateral arrangement only if the collateral has been transferred to the collateral taker or its existence has been noted on the account or register in which the collateral provider's interest is recorded. Accordingly, third parties who deal with a collateral provider are not at risk of being misled about the status of the collateral provider's interest in the collateral as long as they make reasonable enquiries."

The thinking of the Commission appears therefore to have been, at that early stage, that the need for protection of third parties and the avoidance of fraud was sufficiently met by transfer of the collateral, or appropriate designation of it as collateral in the account or register in which the provider's interest was recorded.

109. In April 2001 the European Parliament referred the Commission's proposal to the Committee on Economic and Monetary Affairs and to the Committee on Legal Affairs and the Internal Market. On 23 November 2001 the Committee on Economic and Monetary Affairs made its report, consisting mainly of a Legislative Proposal (which proposed various amendments to the Commission's original draft) and Explanatory Statement. Two of the proposed amendments are relevant for present purposes. First, the Committee proposed (as Amendment 3) a new Article 2(2) as follows:

> "The arrangement must be in writing or evidenced in writing and signed by or on behalf of the collateral provider. This Directive only applies to financial collateral once it has been provided under a financial collateral arrangement and if that provision can be evidenced in writing."

By Amendment 11, a new paragraph 1(a) to Article 3 was to be added in the following form:

> "References in this Directive to financial collateral being "provided" mean the financial collateral being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf."

Under the sub-heading "Justification" the proposal explained that:

> "It is important to make clear that for financial collateral to fall within the scope of the Directive there must be dispossession. A definition of 'provision' is therefore proposed alongside the other definitions in article 3."

110. In its accompanying Explanatory Statement, the Committee made the following observations:

> (On page 18)
>
> "The principle (sic) objectives of the proposal are:
>
> - ensuring that effective and reasonably simple regimes exist for the creation of collateral under either title transfer (including repo) or pledge structures, i.e. providing that the only perfection requirement procedure to follow to protect a collateral agreement should be that the interest be notified to, and recorded by, the relevant intermediary maintaining the securities account;
>
> (On page 20)
>
> - a second key issue is whether a collateral arrangement needs to be concluded in writing and signed, as the Commission proposes. A number of Member States abolished such a requirement sometime ago and therefore would regard its imposition in the Directive as a negative step. On the other hand, some countries currently require collateral arrangements to be concluded in writing and signed. I have therefore envisaged a compromise solution on this issue. This states that it would be sufficient for the collateral 'provided' ('delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker') so long as that 'provision be evidenced in writing'. This would

> mean that so long as a written trace (defined as including recording in electronic form) could be found of the provision of collateral, it would fall within the scope of the Directive.
>
> …
>
> The whole question of the balance of the legal framework for collateral and the provisions of insolvency law is a delicate one. While financial ministries want to promote the use of collateral to ensure a more liquid capital market, national ministries of justice are concerned that the rules in article 9 which disapply certain insolvency provisions will benefit collateral takers to the exclusion of other creditors in the event of a company becoming insolvent. In my view the Commission has taken a balanced approach to this Issue which deserves support."

111. Pausing there, Mr Milligan submitted that a fair reading of the Committee's report showed that the proposal to introduce, for the first time, the possession or control requirement was intended to be a compromise between rival views for and against a requirement that qualifying financial collateral arrangements should be not merely in writing, but signed. 'Provision', in the sense of delivery, transfer, holding, registration or other designation so as to be in the possession or under the control of a collateral taker was the *quid pro quo* for the decision that there need only be evidence in writing. He suggested, with considerable force, that it would have come as a surprise to the Committee, or to any reader of its report, to hear that the compromise proposal called not merely for some form of transfer, holding, registration or designation to be evidenced in writing, but also for the proof, by way of additional condition, that the collateral was thereby in the legal or administrative control of the collateral taker, beyond merely having been transferred, held, registered or appropriately designated. He said it showed that the concepts of dispossession (which later appeared by amendment in Recital (10)) and "possession or control" were intended to be satisfied by written evidence of transfer, holding, registration or other designation, rather than superimposed as additional requirements going way beyond any compromise between a requirement for writing, and the competing requirement for signed writing.

112. Five days after the Committee's report, an opinion was delivered by the Economic and Social Committee, on 28 November 2001, on the Commission's proposal in its original form. In summary, it took a much more pro-creditor protection view of the balance to be struck than had been proposed either by the Commission or by the Committee on Economic and Monetary Affairs. For example, at paragraph 3.4, it spoke of the risk of perverting the principles of bankruptcy and the corresponding protection of creditors. In paragraph 4.1 the Committee considered it unacceptable that "this innovative mechanism is going to be applied without a freely accessible mechanism for general consultation being set up at the same time to provide real-time information on all the collaterals of this type provided by the various operators concerned". At paragraphs 4.2 and 4.3 the Committee envisaged a mandatory database being set up at the European Central Bank or other independent and credible institution designed to provide for the accessible registration of all collateral of this type for as long as they exist, so as to provide the requisite transparency and security

so that all creditors, suppliers and shareholders etc, can have a clear picture at any one moment of the real situation regarding the collateral provider's assets.

113. The Economic and Social Committee's proposal was not adopted in the final form of the Directive, but its Opinion was expressly referred to in the preamble to the Directive, as something to which the European Parliament and Council had regard.

114. It is apparent from the passages in the Recitals and the operative provisions of the Directive in its final form which I have already recited that the substance of the amendments proposed by the Committee on Economic and Monetary Affairs were accepted by the Parliament, because they found their expression in Articles 1.5 and 2.2, and their justification in Recital 10. Nonetheless it does not appear anywhere in the Directive in its final form (and in particular not from Recital 10 itself) that the Parliament regarded the requirement for dispossession (or its obverse, possession or control) as merely a compromise between a rival requirement for writing or signed writing, in a way suggested by that Committee in the passages from its Explanatory Statement which I have recited. It seems to me equally possible that the Parliament may have concluded that the requirement for dispossession of the collateral provider by demonstrating possession or control in the collateral taker was a reasonable compromise between the more fundamental divergence between the Commission on the one hand and the Economic and Social Committee on the other hand, whereby the requirement for possession and control to be demonstrated was intended to be an important part of the *quid pro quo* to the collateral provider's creditors for the removal of the protection otherwise afforded to them under national law in the event of the collateral provider's insolvency.

115. The implementation of the Directive in the UK by means of the Regulations adds little to this debate, because of the use of almost identical language to that found in the Directive, save in one significant respect. In Regulation 3, the expression "security interest" is defined by reference to five familiar categories, the fourth of which, at sub-paragraph (d) is:

> "A charge created as a floating charge where the financial collateral charged 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; …"

It is evident, at least at first blush, that HM Treasury did not in framing the regulations think that the requirement to show possession or control in the collateral-taker necessarily precluded floating charges from qualifying as relevant security interests, even though it is now well settled that it is precisely the absence of possession or control of the subject matter of an English charge by the chargee that makes it likely to be characterised as a floating rather than a fixed charge. Nonetheless the extensive debate about that question among lawyers and bankers was only resolved some years after the framing of the Regulations, in the *Spectrum Plus* case, in June 2005.

116. The next step in the relevant chronology was the extempore judgment of Vos J in *Re F2G Realisations Ltd: Gray v GTP Group Limited* [2011] 1 BCLC 313 ("the *Gray* case") in May 2010. The case concerned an unregistered floating charge which, if valid, was worth less than £100,000 in the hands of the chargee, in relation to which the consequences of the failure to register were thought to be avoided by a claim that the charge constituted a security financial collateral arrangement under the FCARs. The subject matter of the charge (expressed as a declaration of trust) was the balance in a bank account set up and managed by the chargee as part of the mechanics of the provision of debit card services to the chargor. It was therefore intangible property.

117. Vos J held that the claim under the FCARs failed because the terms of the charge were insufficient to confer control on the collateral taker even though the subject matter of the charge was held by the collateral taker in a bank account in its name. While acknowledging that the phrase "possession or control" had to be given an independent meaning, he held that possession had no sensible application to intangibles, and that there was an absence of control in the collateral taker because, pending crystallisation, the collateral provider had the legal right to require the collateral taker to deal with the deposited money at its direction. The absence of what he called legal or negative control in the collateral taker (due to it having no right to prevent the removal of the charged money from the account by the collateral provider) was in his view fatal to the claim under the FCARs, even though the collateral taker had what he called administrative control, in the sense that, on a day to day basis, it was able to deal with the money as the relevant account holder.

118. The report in the BCLC provides no summary of counsel's submissions but it is plain that the judge did not have presented to him anything approaching the depth and detail of legal argument deployed in the present case. In particular, it does not appear that he was shown any of the relevant *travaux preparatoires*. One of the main points against his conclusion which he does however mention (at paragraph 58) is that his analysis left little room for any floating charge (as understood in English legal terms) to qualify for protection under the FCARs, despite the express reference to it as a potentially qualifying species of security interest in Regulation 3. Indeed, counsel for the liquidators was unable to advance any example (albeit in the heat of battle) of a floating charge which would, under his and the judge's analysis, qualify for protection.

119. The judge's conclusion that control, in the sense of a legal right in the collateral taker to prevent the collateral provider having use of the charged property pending crystallisation, was an essential requirement of a security financial collateral arrangement was based on three main factors: see paragraphs 60 to 62. The first was that the express inclusion of the possession or control requirement in Article 2.2 of the Directive, coupled with the exception permitting the collateral provider to withdraw excess collateral, made little sense if the collateral taker needed only to show administrative rather than legal control. If administrative control was sufficient, then the limited exception of a right to withdraw excess collateral was mere surplusage. The second was that Recital 10 identified dispossession as the key to the striking of the balance between market efficiency and creditor protection. Without a legal right in the collateral taker to prevent the provider from withdrawing the charged property pending crystallisation, the provider was not in any relevant sense dispossessed. Thirdly, and consistent with the views of Professor Beale and others in the 2007

edition of *Law of Personal Property Security*, mere administrative control was not, viewed as an independent concept, control at all.

120. It goes without saying that Vos J's analysis in the *Gray* case formed the bedrock of Mr Salter's and Mr Moore's submissions, and that Mr Milligan and Mr Snowden were constrained to submit that his analysis was wrong, and sufficiently clearly wrong for it to be appropriate for me not to follow it.

121. The decision in *Gray* was quickly followed by a series of critical articles from City commentators, by a fresh edition of Professor Beale and his colleagues' book which recanted on a specific point upon which Vos J had relied, and then by a report of the Financial Markets Law Committee in December 2010, from a working group consisting of distinguished and experienced members of five City firms and two major banks, the gist of all which was to suggest that Vos J's identification of a requirement on the collateral taker to demonstrate legal control over the financial collateral had largely denuded the FCARs of their intended beneficial effect, to the extent that further legislation was required.

122. The published articles to which I was referred included *Financial collateral:an opportunity missed*, by Robin Parsons and Matthew Dening (of Sidley Austin LLP) (2011) Law and Financial Markets Review 164, in May 2011; *The Financial Collateral Directive's Practice in England*, by Look Chan Ho (of Freshfields Bruckhaus Deringer LLP) [2011] JIBLR, Issue 4, and *What should we do about financial collateral?* by Louise Gullifer, (Professor of Commercial Law, University of Oxford) in Current Legal Problems (2012).

123. A common theme in all those materials (namely the publications, the fresh edition of Professor Beale's book and the FMLC report) was that, although Vos J had recognised the need to identify an independent meaning for the phrase possession or control, he had then disregarded possession as a sufficient means of satisfying the test because of a narrowly English law view that possession was irrelevant to intangibles: see in particular Beale (*op. cit.*) at paragraph 3.38, and paragraphs 4.5 to 4.12 of the FMLC report.

124. The more general (but not unanimous) theme of the commentators since *Gray* is that the balance intended to be struck between market efficiency and creditor protection will only be achieved if it is recognised, in relation to intangibles (which form the overwhelming bulk of collateral security in issue), that possession can be demonstrated wherever it is "held" by the collateral taker, that this is sufficient regardless of control, but that to the extent that control is also to be demonstrated, it is satisfied by administrative rather than legal control, for example where the collateral is credited to the name of the collateral taker in the account of the depository. Such features are, it is suggested, amply sufficient to deal with the risks of apparent ownership or fraud referred to in Recital 10 to the Directive. A requirement upon the collateral taker to show that it has a legal right to prevent withdrawal of intangible security held or registered in its name would extract whole swathes of financial collateral in current use in the capital markets from the protection intended to be conferred by the FCARs.

125. The publication of the FMLC report was followed by an amendment to the FCARs made under delegated authority by HM Treasury, which came into force only in April

2011. Apart from correcting the mistaken use of "equivalent financial collateral", it inserted a new Regulation 3.2 as follows:

> "For the purposes of these Regulations "possession" of financial collateral in the form of cash or financial instruments includes the case where financial collateral has been credited to an account in the name of the collateral taker or a person acting on his behalf (whether or not the collateral-taker, or person acting on his behalf, has credited the financial collateral to an account in the name of the collateral-provider on his or that person's books) provided that any rights the collateral-provider may have in relation to that financial collateral are limited to the right to substitute financial collateral of the same or greater value or to withdraw excess financial collateral."

126. Critics of the outcome and analysis in *Gray* may be forgiven for having thought that this provision gave with one hand but took as much away with the other. It purports to recognise that possession may, for the purposes of the Directive, be a relevant concept in relation to intangible collateral, but limited that recognition to the narrow circumstances in which full legal control in the collateral-taker was only subjected to rights of substitution and the withdrawal of excess collateral. It is not suggested that this amendment has any relevant retroactive effect in relation to the enforceability of the security conferred by the MCA (or by the STB) in relation to LBF's insolvency. Its relevance is only that in discharging its duty to understand and apply the Directive within the context of British law, HM Treasury acceded only to an immaterial and largely theoretical extent to the FMLC's invitation to do something by way of ameliorating the restrictive effect of Vos J's analysis.

127. I must now state my own conclusions. I make it clear that I do not regard myself as bound by judicial comity to follow the decision of Vos J unless sure that it is wrong. The matter has been argued so much more fully before me, and by reference to so much more admissible *travaux preparatoires*, and subsequent academic and expert comment, that it is in my view both legitimate and necessary to address the question afresh.

128. The central question is as to the correct interpretation, independent of any national law, to be given to the whole of Article 2.2 of the Directive, rather than to the supposed meaning of any one or more of its words or phrases taken in isolation. That interpretation must be purposive, in the sense that it is responsive to such purpose as can be identified from the Directive as a whole and, in the present context, primarily from the second half of Recital 10. That explains that the balance between market efficiency and creditor protection is to be struck by limiting the scope of the Directive to financial collateral arrangements which provide for some form of dispossession, by which Recital 10 means "provision of the financial capital" provided that the provision can itself be evidenced in writing or in a durable medium. Article 2.2 comprehensively defines what the Directive, and Recital 10 in particular, means by "provision". Article 1.5 implements the requirement for evidence in writing, both in relation to the provision of financial collateral, and in relation to the financial collateral arrangement itself.

129. Contrary to Mr Milligan's able and well researched submissions, I cannot accept his conclusion that the phrase "so as to be in the possession or under the control of the collateral-taker …" in Article 2.2 is merely a description of the invariable consequence of the collateral being "delivered, transferred, held, registered or otherwise designated …" as if the phrase "so as" merely meant "with the result that". On the contrary, I consider it clear that "so as" is better understood to mean "in such a way that". In other words, it is only those forms of delivery, transfer, holding, registration or designation which actually do lead to the result that the collateral is in the possession or under the control of the collateral taker that qualify for inclusion within the regime.

130. I accept that a detailed chronological review of the process whereby the Directive was drafted, proposed, amended and commented upon before being passed by the European Parliament does provide some support for an argument that the mere delivery, transfer, holding, registration or designation of the financial collateral in favour of the collateral taker, sufficiently evidenced in writing, was to be sufficient to tip the balance of including such forms of security within the new regime. It is nonetheless dangerous to read too much into a process of negotiation. Just as English law refrains from treating the parties' negotiations as admissible for the purposes of interpreting their final bargain, so it seems to me that even the most purposive and *communautaire* process of interpreting a Directive is in danger of coming to unsound conclusions if it is too heavily based upon an analysis of the cut and thrust of the debate which preceded it. The interpretation of English legislation by reference to ministerial statements of intent is also kept under control by strict conditions as to admissibility. The same concerns go to the weight to be given to some of the *travaux preparatoires* in relation to European legislation. In the present case, Mr Milligan's submission, which ignored any reference to the opinion of the Economic and Social Committee, necessarily assumes that its much greater concern for the protection of the interests of creditors can be disregarded, when reaching a conclusion that the requirement for dispossession by way of provision was merely a solution to a debate about whether the arrangement, and the provision of the security under it, needed merely to be evidenced in writing, or both written and signed. Since the Parliament thought fit to make express reference to the Economic and Social Committee in the preamble to the Directive it seems to me to be wrong to conclude that the balance struck by the requirement for "provision" as defined in Article 2.2 was confined in the way that Mr Milligan suggests. On the contrary, the natural meaning of the imposition of a requirement for possession or control in the collateral taker, as the means of achieving dispossession of the collateral provider, is that the Parliament took an altogether more cautious view of the extent to which the established protection of creditors afforded by the domestic law of the Member States should be undermined by the new regime or, to put the same point in a different way, a narrower view of the types of financial collateral arrangements which should qualify for immunity from creditor protection.

131. The next stage therefore is to focus upon precisely what is required by the whole of Article 2.2 including and following the expression "so as". I consider that it would be wrong to limit "possession" in such a way as to exclude any application to intangibles, for much the same reasons as I have concluded that the expression "general lien" in the MCA cannot sensibly be taken to exclude any security over intangibles. Intangibles are, and were by the time the Directive was being prepared,

the very stuff of modern financial collateral. There is therefore some force in the criticism of Vos J's analysis that control (whether legal or administrative, negative or positive) lies at the heart of the concept of possession or control. It seems to me that Article 2.2 clearly contemplates that a particular form of delivery, transfer, holding, registration or designation may be sufficient to establish possession but not control, or control but not possession, but that in either case the requirements of Article 2.2 would be satisfied. But in my judgment, both "possession" and "control" mean something more than mere custody of financial collateral by the collateral taker under an agreement giving the custodian no more dominion over it than that of a pure nominee. Whether the MCA gives LBIE any greater dominion is a separate question, to which I will return.

132. I agree with Vos J's conclusion that the exclusion of rights of substitution or the withdrawal of excess collateral from matters derogating from the requisite provision of the collateral points clearly to a meaning of "possession or control" that requires something much more than mere holding by, or delivery or transfer to, the collateral taker as sufficient to qualify. If a mere holding or transfer were sufficient, it is difficult to understand why there was any need to make reference to rights of substitution or withdrawal at all. I am not however persuaded (as HM Treasury apparently has been) that the final sentence of Article 2.2 is a comprehensive description of the rights which may, after a qualifying provision, nonetheless reside with the collateral provider, such that the enjoyment by the provider of any different or wider rights would be fatal to the requirement for provision. It may well be that the draftsman regarded rights of substitution and withdrawal of excess as so common within modern forms of financial collateral arrangement that they needed to be preserved, in the new regime, for the avoidance of doubt.

133. In fact, the breadth of that exception should not be underestimated. A right to substitute collateral means that, in relation to any specific part of the existing collateral, the provider has a complete right to withdraw it, as long as he provides something of equivalent value in return. Similarly, a right to withdraw excess collateral gives the provider the ability to reduce the collateral as a whole, by the withdrawal of any items which he chooses, to whatever low (or sometimes non-existent) level as may be required from time to time by the state of account between him and the collateral taker. If one asks what possession or control is left to the collateral taker under an arrangement which gives the provider such rights of substitution and withdrawal, it is only a right to have maintained a collateral pool, at whatever level is, from time to time, required under the agreement or arrangement pursuant to which the security is given. That may be current indebtedness or, as in clause 9 of the MCA, the collateral taker's reasonable estimate of its exposure. But the right to the maintenance of a collateral pool is far removed from rights amounting to dominion over any particular asset in it.

134. Next, I consider that the reference in the last sentence of Article 2.2 to <u>rights</u> of substitution or withdrawal strongly suggest that Vos J's preference for legal rather than administrative control as the appropriate criterion was correct, notwithstanding the trenchant criticism of that conclusion in the subsequently published commentaries. More generally it seems to me that the concept of dispossession of the collateral provider is little more than meaningless if the terms of the arrangement are such that the provider can demand, at any time, either the return of the collateral, or its

disposition in accordance with the provider's instructions, without any right in the collateral taker to refuse. Not only is it meaningless to speak in those circumstances of the collateral taker being in control of the collateral, it is also contrary at least to business commonsense to describe the taker as being, in any commercial sense, in possession of it.

135. There is in my view nothing at all in the criticism that Vos J's analysis apparently rendered nugatory the express inclusion of floating charges as potentially qualifying forms of security interest under Regulation 3. Although counsel for the liquidator could not during a short hearing about a low-value matter call to mind any example of a floating charge which could qualify under the FCARs, it is in fact obvious that many may indeed do just that. For example, as LBIE concedes, the mere existence of a right of substitution is a badge of a floating charge, but such a right does not prevent an otherwise compliant floating charge from qualifying as a security financial collateral arrangement under the FCARs.

136. It follows that I broadly agree with Vos J's analysis of the possession or control requirement, save for his apparent inclination to think that possession is of minimal relevance where the financial collateral takes the form of intangibles. In my judgment what needs to be shown (in order to bring a particular collateral arrangement within the protection of the FCARs), is that the terms upon which it is "provided" (Article 2.2) or "delivered, transferred, held, registered or otherwise designated" (Regulation 3) are such that there is shown to be sufficient possession or control in the hands of the collateral taker for it to be proper to describe the collateral provider as having been "dispossessed" (Recital 10). There will be cases in which the collateral is sufficiently clearly in the possession of the collateral taker that no further investigation of its rights of control is necessary. In other cases, such as the case before Vos J, it will be necessary to analyse the degree of control thereby conferred on the collateral taker. There may be some cases, in particular where there is no delivery, transfer or holding to or by the collateral taker, but merely some form of designation, where the collateral remains wholly in the possession of the collateral provider, but on terms which give a legal right to the taker to ensure that it is dealt with in accordance with its directions.

137. I also consider that Vos J was plainly correct to conclude, on the facts before him, that the possession or control test was not satisfied. At paragraphs 16 to 19 of his judgment he described the collateral provider's money as held in a trust account in the name of the collateral taker at the Royal Bank of Scotland, on terms that the provider should have the uncontrolled right to call for that money, with no right of set-off being exercisable by the taker. The account was, pending crystallisation of the floating charge, a mere "conduit" between the collateral provider and its paying customers. In the language of the Directive and FCARs, there was no "dispossession": see paragraph 61.

138. It by no means automatically follows that the application of the possession or control test to the MCA produces the same answer. It is necessary to consider more closely than I have done thus far what precisely are the rights conferred upon LBIE in relation to LBF's property held by LBIE as custodian, pending the crystallisation of what I have concluded is LBIE's charge over that property, in the event of default by LBF. For this purpose the relevant clauses of the MCA are 2, 5, 7, 9, 13 and 15.

139. Clause 2 prima facie requires the custodian to hold the client's property in a custody account or accounts ("the Custody Account") in the name of the client. Clause 5 requires the custodian separately to identify the client's property held on its behalf in its records. Clause 5(b) permits pooling of the client's property with the property of one or more other clients of the custodian, and a limited degree of use for the purposes of other clients (where the property is not separately identifiable as the property of individual clients). This would, for example, apply to a block of shares of the same type or, for that matter, to client money. Clause 7 permitted the custodian to be registered as the holder of the property of the client and, in limited circumstances, to pool clients' property with its own property in particular jurisdictions. Clause 9 gave the client the right to demand immediate withdrawal of all or any part of its property in the Custody Account at any time during the period of the agreement and, pursuant to clause 15, on the expiry of a 30 days written termination notice. Both rights were expressed to be subject to clause 13. The final sentence of clause 9 provides that:

> "The Custodian 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."

This provision was not expressed to be subject to clause 15. On the contrary, it is in my judgment a written explanation of the precise extent of the custodian's right to retain the client's property, pending a default i.e. pending crystallisation of what is now acknowledged on all sides to be the floating charge created by clause 13. It was indeed the last sentence of clause 9 which eventually drove LBIE to accept that the client (LBF) had what was in substance a right to withdraw excess collateral, and a right to substitute. In this context, "excess collateral" means property in the Custody Account in excess of the property which the custodian believes will be sufficient to cover any exposure that the custodian has to the client.

140. There was a minor debate between the parties as to whether LBIE as custodian had a wider right than that conferred by the last sentence of clause 9 as against the client's property, once it had communicated a three days' notification of non-performance to the client (as a prelude to sale) pursuant to clause 13. Mr Snowden submitted that, in order to give commercial effect to the security right of sale, there was to be implied an unqualified right of retainer by the custodian of all the client's property from the moment of notification. His opponents' case was that the custodian's right of retainer was never greater than that conferred by the last sentence of clause 9.

141. It is unnecessary for me to resolve that question. What matters for the purposes of the possession or control test is the identification of the parties' rights with respect to the financial collateral during the period before crystallisation (in the case of a floating charge). In my judgment the process of crystallisation is triggered (albeit not completed) by the sending of a three days' notification of non-performance. The rights thereby conferred, if greater than those already existing pursuant to the last sentence of clause 9, are part and parcel of those requisite for giving effect to crystallisation.

142. The custodian's right under clause 9 to retain sufficient property to cover its own reasonable estimate of its exposure to the client must in my judgment be sufficient to

enable the custodian to take into account both future and contingent liabilities, at a reasonable estimate of their value, by way of an addition to debts which are due and payable. It does not confer a right on LBIE to retain an additional amount sufficient to cover its reasonable estimate of LBF's liabilities to LBIE's affiliates, even though the affiliates' debts are within the confines of liabilities covered by the security in clause 13, once it has crystallised.

143. Standing back therefore, the security provisions of the MCA gave LBIE a floating charge over a potentially large pool of differentiated assets, coupled with a limited right of admixture of those assets with other clients' and its own property, subject to a full floating security exercisable by sale and application of proceeds and other monies upon crystallisation, and a right of retainer, but only in relation to its own claims, rather than its affiliates' claims, upon LBF.

144. Looked at in terms of legal right, I have to decide whether for the purposes of the FCARs it is necessary to treat the security for LBIE's claims on LBF as a separate arrangement from the security for the claims of LBIE's affiliates. If treated separately then, subject to the question of conduct to which I shall shortly come, I would have concluded that the MCA conferred a sufficient combination of possession and control on LBIE in respect of the security for its own claims. In that respect I would not regard LBIE's rights of pooling with its own property as adding much to its possession or control. But the property was delivered, transferred to, held by or (in certain jurisdictions) registered in the name of LBIE with a sufficient right to retain it, pending crystallisation, to render LBF's rights as provider not significantly greater than rights of substitution or the withdrawal of excess.

145. Conversely, in so far as the MCA can properly be regarded as a separate arrangement for the provision of security for LBF's debts to LBIE's affiliates, it conferred no meaningful rights of retainer on LBIE pending crystallisation. That may have been an accident caused by tacking on the right of retainer to clause 9 rather than to clause 13, but no one suggested that the last sentence of clause 9 was ambiguous, or susceptible to rectification. Accordingly, viewed separately, the security conferred in relation to LBF's debts to LBIE's affiliates would not qualify for protection under the FCARs, there being no sufficient dispossession of LBF in relation to the property held by LBIE as custodian by reason of that security.

146. While it is conceptually possible to analyse the MCA as creating two separate securities for those separate classes of LBF's liabilities, one compliant with the FCARs and the other not, I am by no means persuaded that this is an appropriate task in the context of a single security apparently created by the same language in two short provisions of the MCA, in respect of the same property. If the advantages conferred upon collateral takers under the Europe-wide scheme of financial collateral arrangements, in terms of immunity from the national law systems for creditor protection in insolvency, are to be satisfactorily applied, in a scheme which, according to Recitals (3), (9) and (17) is meant to serve the objectives of market efficiency, the avoidance of administrative burdens, rapidity and ease of enforcement, it does not seem to me that the national courts should be over-active to identify and extract from the wreckage of a security which, viewed as a whole, fails to satisfy the possession or control requirement, a smaller kernel of security which does. The question whether there has been dispossession of the collateral provider should be addressed in my

judgment by reference to the parties' legal rights in relation to each separately identified part of the property constituting the collateral security, viewed as a whole.

147. Here, there is only one class of collateral security, namely all property held by LBIE for LBF as custodian, and in my view the distribution of the parties' respective rights to it, pending crystallisation, are insufficient to satisfy the possession or control requirement. This is because LBF retained, pending crystallisation, uncontrolled rights of recall and disposal of the property held in custody to a substantially greater extent than rights of substitution or withdrawal of excess, treating "excess" as referable to the whole of its liabilities for satisfaction of which the security existed. In short, leaving aside its debts to LBIE, LBF could do what it liked with the property, regardless of its liabilities to LBIE's affiliates. I should add that neither Mr Milligan nor Mr Snowden gave reasons why I should separate out the security, as between LBF's debts to LBIE and its debts to LBIE's affiliates. Their submissions were aimed, almost from start to finish, at the more radical proposal which I have rejected, namely that LBIE had sufficient possession of LBF's Property (merely as its custodial holder) to render any fine analysis of the extent of its rights of control pending crystallisation unnecessary.

148. I have reached the conclusion that the security rights conferred by the MCA fall short of a qualifying security financial collateral arrangement under the FCARs without having to decide the additional legal question whether, whatever the legal rights, it is appropriate to take into account the parties' conduct or alleged non-exercise of those rights, and the factual question whether there is sufficient evidence of non-exercise in the present case, to disqualify the security under the FCARs, regardless of the strict legal rights which it conferred. Nonetheless, and against the risk that a higher court might be prepared to separate out the security into qualifying and non-qualifying parts in a way that I regard as inappropriate, I should briefly deal with those further questions, which would arise in relation to the security created by the MCA in relation to LBF's liabilities to LBIE.

149. It was established in *Spectrum Plus* in relation to the English law question whether a security constituted a floating charge, that the habitual non-use of apparent rights of control over the security property could lead to what looked like a fixed charge being identified, in substance, as a floating charge: see per Lord Scott at paragraph 119 and per Lord Walker at paragraph 140, in both cases following Lord Millett's dictum in *Agnew's* case [2001] 2 AC 7010 at paragraph 48. In that case the question was whether the customer's money was paid into a blocked account at the bank, it being insufficient for the account to be treated as blocked by implication merely because the bank was expressed in the debenture to have a fixed charge over the money. The parallel in the present case arises from the apparent right of LBIE to refuse LBF's requests for delivery of security property under the last sentence of clause 9 of the MCA where, in its reasonable opinion, LBIE needed to retain the property to cover its exposure to LBF's debts.

150. Paragraph 10.13 of the Agreed Statement Facts records that:

> "Prior to the collapse of the Group, LBIE did not exercise any legal rights of control it may have had under the LBF MCA … or the LBF STB over assets the subject of the Security Interests in those agreements."

The MCA was, as I have said, a standard form of document normally used for LBIE's dealings with street clients put in place, as between LBIE and LBF, to provide documentary evidence of its duties as custodian in relation to LBF's assets, so as to satisfy Taiwanese regulatory authorities. The generality of paragraph 10.13 of the Statement of Agreed Facts extends as much before the making of the MCA as after it. The limited right of retainer conferred by the last sentence of clause 9 upon LBIE was one which had never previously been exercised, nor was it exercised thereafter. It is not however suggested that any part of the MCA can, as between LBIE and LBF, properly be regarded as a sham. The effective use of such a right of retainer would have required LBIE to monitor not merely its daily or weekly aggregate balance of account with LBF, but also its exposures in relation to LBF's future and contingent liabilities, arising out of the totality of its business with LBIE. There is no evidence that any monitoring of this kind took place, although LBIE had the means of knowing, and routinely did know, the state of its aggregate current accounts with LBF.

151. There are I think two obstacles in the way of taking account of this aspect of the parties' conduct towards each other in deciding whether the FCARs apply to the security interest created by the MCA in respect of LBF's debts to LBIE. The first is that there is a real difference in my view between taking account of conduct in order to identify the parties' apparent rights in relation to a matter about which the agreement in question is silent, and doing so where the agreement in question confers a clear express right of control by retainer, which is not alleged to have been a sham. Both in *Spectrum Plus* and *Agnew*, the relevant agreements were silent as to the way in which the account into which money, described as the subject matter of a fixed charge, was to be used, but the parties' conduct made it clear that the account in question was an ordinary rather than a blocked account, in relation to which the debtor had an unrestricted right to draw, pending the happening of a crystallising event. In the present case by contrast, the final sentence of clause 9 of the MCA gives LBIE a precise express right to refuse to deliver property held in the Custody Account to the extent necessary to protect its reasonable estimate of the amount of its exposure.

152. The second objection is the use of any such technique for the purpose of assessing whether a particular security interest qualifies under a Europe-wide regime for the provision and protection of financial collateral. I am less persuaded by this objection. To the extent that the qualification of any particular arrangement as a security financial collateral arrangement under the FCARs depends on an analysis of the parties' respective rights of possession and control over the collateral, I see no reason why English law techniques of analysing that question (as used in the *Agnew* and *Spectrum* cases) should be any less available to the court when analysing the same question under regulations designed to implement a Europe-wide scheme. Nonetheless, I consider that the first objection is sufficient in the present case to mean that the mere non-use (before and after the making of the MCA) of LBIE's right of retainer is insufficient to have swung the balance against a conclusion that the qualifying conditions of the FCARs were satisfied, had I otherwise been inclined to do so.

Retroactivity

153. My conclusion that the security interest conferred on LBIE by the MCA does not qualify as a security financial collateral arrangement under the FCARs

makes it strictly unnecessary for me to address the hotly debated question whether, in any event, the FCARs came into force too late to be capable of applying to the MCA, made as it was a few months earlier in 2003. Nonetheless, for the same reasons as before, I will briefly address the question. Mr Moore submitted that, in accordance with the general tendency of the courts to interpret legislation as having non-retroactive effect, I should conclude that the FCARs apply only to financial collateral arrangements made after their coming into force, in December 2003. Mr Milligan and Mr Snowden's contrary submissions do not challenge the general principle. Their case was that the application of the FCARs to the MCA does not involve retroactivity, save in certain very limited respects. Their main point was that the effect of non-registration under section 395 of the Companies Act was not to invalidate a charge *ab initio*, or at all as between chargor and chargee, but only to render the charge unenforceable against the liquidator or creditors of the chargor, in its subsequent liquidation. Accordingly, to give effect to the FCARs as displacing the invalidation of an unregistered floating charge by reference to a security financial collateral arrangement made before their coming into force would involve no retroactivity in relation to any insolvency process initiated in relation to the chargor after December 2003.

154. By contrast, Mr Snowden and Mr Milligan recognised that there could be retroactivity if the disapplication of a registration requirement in relation to a pre-December 2003 floating charge upset security rights accrued by December 2003, for example in favour of a subsequent floating chargee who had obtained registration. This they said could be avoided simply by treating the FCARs as not having that particular retroactive effect. They also accepted that the disapplication of section 53(1)(c) of the Law Property Act 1925, in relation to a pre-December 2003 arrangement, purporting to transfer an existing beneficial interest otherwise than in writing, would also be retroactive, because that provision led to voidness rather than mere avoidability.

155. I was taken to considerable authority on the English law and European principles about retroactivity in the interpretation of legislation. They were not significantly in dispute. For both purposes, the question is ultimately one of Parliamentary intention, such that a clear intent to legislate retroactively must be identified, in particular where to do so would disturb accrued rights.

156. At my invitation Mr Milligan and Mr Snowden also canvassed an intermediate possibility, namely that the FCARs applied only to financial arrangements completed by the provision of relevant security property after December 2003. If correct, this would have been sufficient for the purposes of LBIE and 314 CA, since virtually all the security property in issue by the time of the crash was provided to LBIE (not only by LBF, but by other companies under standard form arrangements) long after that date.

157. My conclusions are, in brief, as follows. First, there is no express provision either in the Directive or in the FCARs which clearly discloses a legislative intention that they should have, or should not have, retro- active effect. Secondly, I accept the broad thrust of Mr Snowden's and Mr Milligan's submissions that the primary effect of the dispensation from the registration requirement of section 395 achieved by the FCARs is not retroactive, in the

sense that the scheme for registration under section 395 is not designed to provide real protection for unsecured creditors ahead of the descent of the chargor company into insolvency. For example, solvent companies not infrequently obtain the court's permission to register charges out of time, even though there may be persons who have given unsecured credit to the company in the meantime.

158. Thirdly, there is clearly potential for retroactive effect of the dispensation against the section 395 registration requirement in relation to priorities between the proprietors of registrable charges, and in relation to persons giving unsecured credit before the coming into force of the FCARs, on faith of an assumption (after a search) that the chargor company had given no registrable charges. Fourthly, the FCARs are clearly capable of having a retroactive effect in relation to the dispensation from section 53(1)(c) of the Law of Property Act 1925.

159. Finally, and conclusively in my judgment, both the FCARs and the Directive are forms of essentially conveyancing legislation, designed to prescribe, for the future but not for the past, that financial collateral arrangements entered into in a certain form will enjoy protection against requirements as to form and registration under the differing laws of Member States, for the purposes of market efficiency, costs saving and convenience. In terms of public policy those benefits are to be afforded not to cure some existing evil, and expressly at some cost to the existing provisions of national law, designed for the benefit and protection of creditors in particular. They were clearly not intended to relieve persons from the consequences of an existing failure to comply with applicable requirements of their local law, some of which (such as failure by the chargor company to register) give rise to criminal consequences. I consider that where the legislature (whether European or national) adjusts a dividing line between competing public benefits by prescribing procedures and forms of transaction which will qualify for a particular type of privilege or protection from national law, it is intended primarily for the benefit and protection of parties using those prescribed forms and procedures after they have been brought into force by Member States. The Directive sets a deadline, in Article 11, for bringing national implementing legislation into effect. It is to financial collateral arrangements made after the implementing date that I consider that both the Directive and the FCARs were intended to apply. Although there are some indications that a qualifying arrangement is incomplete until the security has been provided, I consider nonetheless that it is to the transaction which sets up the arrangement rather than the provision of security under it, that both the Directive and the Regulations are primarily focused, and to which any issue of retroactivity must be directed.

160. The result of this necessarily long and tortuous analysis is that the answer to Issue 6 is, simply:

a) The FCARs do not apply to any Security Interest created by agreements entered into before 26 December 2003.

b) The charges created by the MCA do not constitute a security financial collateral arrangement for the purposes of the FCARs.

Issue 7 : If the answers to 6(a) or (b) is no, does section 53(1)(c) of the Law of Property Act 1925 apply, such that the granting of the Security interest over the Assets is ineffective where the disposition is not in writing signed by the person disposing of the same, or by his lawfully authorised agent?

161. Section 53 of the Law of Property Act 1925, headed 'Instruments required to be in writing', provides so far as is relevant as follows:

> "(1) Subject to the provision hereinafter contained with respect to the creation of interests in land by parol –
>
> …
>
> (c) a disposition of an equitable interest or trust subsisting at the time of the disposition, must be in writing signed by the person disposing of the same, or by his agent thereunto lawfully authorised in writing or by will."

By section 205 (1)(ii):

> " "Conveyance" includes a mortgage, charge …; and "disposition" includes a conveyance …."

Thus, as is common ground, a charge of an equitable interest subsisting at the time of the creation of the charge must be in writing and signed by the chargor or his agent.

162. It is common ground that the MCA was indeed signed by or on behalf of LBF and that section 53 is therefore no obstacle to the enforcement of the charge created by clause 13. Nonetheless the section 53 argument was pursued in relation to the MCA on behalf of LBI, on the footing that, representing ownership affiliates, there may exist property charged under a similar form of agreement by some other Lehman companies in favour of LBIE which, like the STB which I shall have to address later, was not signed by the chargor. Nothing in the different language of the MCA and the STB gives rise to different section 53 issues, and it is convenient therefore to deal with the section 53 questions in full at this stage, taking on board for that purpose the arguments addressed to it by Mr Salter on behalf of LBF in relation to the STB.

163. It is an essential part of the English law analysis of the ownership of dematerialised securities that the interest of the ultimate beneficial owner is an equitable interest, held under a series of trusts and sub-trusts between it, any intermediaries and the depository in which the legal title is vested: see paragraph 226 of my judgment in the *RASCALS* case. Thus, viewed from any moment in time after the creation of a clause 13 (MCA) charge of dematerialised securities of which LBF was the beneficial owner, it was a charge over an equitable interest in securities. In relation to securities acquired by LBF prior to the making of the MCA (and not already charged as a result of some earlier now undocumented dealing between the parties), it is common ground that section 53(1)(c) applied since the equitable interest out of which the charge was created was already subsisting in the hands of LBF when the MCA was made. But there is likely to be little if any of that property remaining in LBIE's hands now, or even at the time of the collapse. It is almost certain that the bulk of the property still

subject to the clause 13 charge by the time of the onset of LBF's insolvency had been beneficially acquired by LBF after the making of the MCA and, in all probability, held by LBIE as LBF's custodian from the moment of its acquisition from the street. Ownership in terms of the whole of the equitable interest against the depository legal owner (or intermediate trustee) will pass straight from the street vendor to LBIE as LBF's custodian, with an immediate sub-division of that beneficial interest between LBIE as chargee and LBF as the ultimate beneficial owner. There will be no moment in time during which LBF's equitable interest subsists before the charge in favour of LBIE is carved out of it.

164. There are on that analysis two reasons why in my view section 53(1)(c) has no application. The first is that there is no moment in time (*scintilla temporis*) during which the beneficial interest in the dematerialised securities, out of which LBIE's charge is carved, subsists in LBF. I reach this conclusion by analogy with the analysis of the House of Lords in *Abbey National Building Society v Cann* [1991] AC 56 in which the notion that, upon the acquisition of a dwelling-house with the assistance of a mortgage, the mortgagee held it for a moment in time prior to the creation of the mortgage was firmly disapproved. The result was that the ownership of the property did not vest in the mortgagor for sufficient time for the buyer's mother to obtain an interest in it protected by her occupation, in priority to the bank's mortgage. In that context I accept Mr Moore's submission that the *Cann* case was about priority rather than formalities, but I nonetheless consider the analogy to be a good one. It was applied to company charges by HHJ John Newey QC in *Stroud Architectural Systems Ltd v John Laing Construction Ltd* [1994] 2 BCLC 276.

165. The second reason is that by parity of reasoning with *Vandervell v IRC* [1967] 2 AC 291, section 53(1)(c) is simply not aimed at a transaction by which the equitable interest in property created by the grantor under the disposition in question comes to him not from the grantor but pursuant to the grantor's direction that the owner of the property out of which that equitable interest is carved transfer it direct to the grantee. In the *Vandervell* case the appellant directed his bank to transfer certain shares which they held for him on bare trust to an intended donee. The Crown argued, unsuccessfully, that the appellant had failed to divest himself of his beneficial interest, due to the absence of sufficient signed writing under section 53(1)(c). The House of Lords held that section 53 had no application to the transaction. The appellant's beneficial interest in the shares was carried to the donee by the bank's transfer of its legal ownership of them at his (oral) direction, it being his intention that his equitable interest should pass thereby. At page 311 Lord Upjohn said this, of section 53:

> "the object of the section, as was the object of the old Statute of Frauds, is to prevent hidden oral transactions in equitable interests in fraud of those truly entitled, and making it difficult, if not impossible, for the trustees to ascertain who are in truth his beneficiaries. But when the beneficial owner owns the whole of the beneficial estate and is in a position to give directions to his bare trustee with regard to the legal as well as the equitable estate there can be no possible ground for invoking the section where the beneficial owner wants to deal with the legal estate as well as the equitable estate."

166. It is true that, in the present context, there will have been few if any instances where LBIE received legal rather than beneficial title to dematerialised securities from LBF's vendor on the street. Nonetheless, it received as custodian the whole of the interest which the vendor had, and out of which its charge was simultaneously carved by virtue of clause 13 of the MCA. LBF's claim (in fact in relation to the STB which was not signed, rather than to the MCA which was) is based upon asserting the validity of the transfer to LBIE of its street vendor's interest in the securities, while denying the validity of the charge over that interest pursuant to an agreement which, it asserts, was fully binding between itself and LBIE, albeit lacking its signature.

167. I can see no reason why the reasoning in the *Vandervell* case should not apply where, instead of a legal interest, there is transferred a superior equitable interest, out of which the equitable interest in question (here the equitable charge) is carved.

168. My answer to Issue 7 is therefore as follows:

i) As between LBIE and LBF, the MCA was signed on LBF's behalf, so that no question under section 53(1)(c) can arise.

ii) In the case of an equivalent agreement to the MCA between LBIE and an affiliate, written but unsigned, section 53(1)(c) may apply where the beneficial interest subject to the charge was held by the chargor prior to the making of the MCA type agreement. But where LBIE acquired title (whether legal or equitable) to the relevant dematerialised security from a vendor to the chargor, such that the charge under the agreement arose simultaneously with that transfer of title, then section 53(1)(c) has no application.

Issue 8: If the answers to 6(a) or (b) and 7 are, in both cases, no and the Security interest takes the form of a floating charge, is the floating charge liable to be declared invalid under section 245 of the Insolvency Act 1986 except to the extent of the aggregate of the new value given in consideration for it (as more fully described in section 245(2) of the Insolvency Act 1986)?

169. In relation to the floating security created by the MCA, there can be no question of the application of section 245 of the Insolvency Act, because the relevant floating charge was not created at a relevant time within the meaning of section 245(2): see section 245(3)(a). But different considerations arise in relation to the STB, which was indeed made at a relevant time. I will address those issues in the part of this judgment which focuses upon the STB.

Issue 9: Are the rights created by clause 13 capable of applying to:

i) **An Affiliate's assumed Client Money entitlements (to Client Money received before 7.56 am on 15 September 2008) and/or (ii) Client Money held by LBIE for an Affiliate which was received at or after 7.56 am on 15 September 2008?**

When answering question (i) and (ii), any facts stated in the Appendix should be assumed.

170. Mr Salter and Mr Moore took two quite separate objections to an affirmative answer to this question, neither of which focused upon the suggested distinction as to dates of receipt, either side of 15 September 2008. I will need to deal with each objection separately.

171. Mr Salter's objection was, as he readily acknowledged, wholly dependent upon a conclusion that a security right created by clause 13 of the MCA was purely personal or contractual rather than proprietary. In the light of my conclusion to the contrary, I can deal with his objection briefly. He said that a purely personal right could not impinge upon LBF's proprietary claim under the Client Money rules, being a right in the nature of set-off, and that in any event LBIE could not contract out of the statutory obligation as Client Money trustee to distribute the Client Money Pool rateably in accordance with Client Money entitlements pursuant to CASS 7.9.6 R(2).

172. I consider that there is no substance in either of these objections. Even if the security right created by clause 13 was some form of flawed asset right, reducing the value of LBF's interest in the relevant property while held as custodian by LBIE, I can see no reason why LBIE's contractual right of sale and application of the proceeds should not stand in the way of the quantification and distribution under the Client Money rules to LBF on account of it. Nor can I understand why the existence of such a right should amount to some illegitimate contracting out of the Client Money rules by LBIE, merely because security rights of that esoteric type are not expressly mentioned in them.

173. Mr Salter attempted to draw a distinction between client money deposited with LBIE by LBF, and client money coming into LBIE's hands as custodian for LBF by some other route such as from a third party or upon the receipt of proceeds of sale of some client asset. Again, I can see no point of principle in these distinctions. It is correct, as Mr Salter asserts, that the security rights in clause 13 are strictly limited in their application to Property (as defined) held by LBIE as custodian under the MCA. Whether any specific property is or is not so held is likely to be a fact intensive matter and in any event, by agreement, beyond the scope of this judgment.

174. Mr Moore submitted that there could be no charge or other security right in relation to any "Client Money entitlement" of LBF under the CASS rules. This was, he said, because a Client Money entitlement was an obligation owed by LBIE to LBF, not an asset in LBIE's hands capable of being subjected to a charge, still less property "held by" LBIE as custodian under the MCA. This was a submission advanced regardless of the nature of the security right created by clause 13.

175. Again, I consider it to be without substance. A "Client Money entitlement" under the CASS 7 Rules is not an asset but an amount by reference to which a client's right to share in the Client Money Pool is calculated: see for example CASS 7.9.6. To the extent that LBIE has relevant security rights in relation to money held for a client the amount of which would otherwise go to swell that client's Client Money entitlement, then the existence of those rights will simply reduce, *pro tanto*, the amount of the Client Money entitlement.

176. I can envisage that there may be some difficult questions of detail arising out of the decision of the Supreme Court in the *Client Money* case that both the Client Money Pool and the Client Money entitlements are to be identified and calculated by

reference not merely to money which LBIE did segregate and hold as client money, but to money which it ought so to have held. Putting that question into the language of the MCA, there may be issues as to whether the clause 13 security interest only affects money actually held by LBIE as custodian, in respect of which it complied with its contractual and regulatory duties to identify and segregate, or also to money which LBIE ought so to have identified, segregated and held. I consider them both questions are beyond the scope of this judgment. They were not debated at any length by counsel in their submissions, and the agreed and assumed facts tell me too little about what if any client money may still be identifiable outside client money accounts, and if so where, to make it possible for me to give more than purely theoretical, and therefore probably unhelpful, answers to this further question.

Issue 10: Did the LBF STB supersede the LBF MCA such that the Security Interest granted under the LBF MCA is no longer enforceable?

177. The STB was drafted, like the MCA, primarily for use between LBIE and its street clients, as a fresh set of general terms and conditions of business designed to be compliant with the requirements of the Markets in Financial Instruments Directive ("MIFID"), which was due to come into force in the UK on 1 November 2007. Although it was not LBIE's invariable practice to update such standard terms and conditions as between itself and other Lehman affiliates, it did so on this occasion with LBF, sending a copy of the STB to LBF's head office in Zurich under cover of a letter (calling itself a "Client Letter" dated 28 September 2007). The Client Letter was mainly concerned with issues about client categorisation, with which these proceedings are not concerned. The Client Letter did not request LBF to sign or even acknowledge receipt of the enclosed STB, although it is common ground that it was in fact sent and received.

178. Paragraph 2 of the Client Letter, headed "Terms and conditions of our service" stated:

> "This letter ("the Client Letter") and the enclosed Lehman Brothers International (Europe) Terms and Conditions document, and the annexes thereto (the "Terms and Conditions"), shall collectively constitute the contractual agreement between us as from 1 November 2007. Please note that the Terms and Conditions apply subject to the modifications set out at Annex 1 thereto.
>
> Your existing Market Counterparty Notice document will continue to govern the relationship between us and you up to and including 31 October 2007, after which date this Client Letter and the Terms and Conditions will supersede and replace any agreement between us on the same subject matter."

179. The STB, headed Terms and Conditions contains, at the beginning of clause 1 headed GENERAL a sub-clause (A) headed THE SCOPE as follows:

> "This document sets out the terms and conditions under which we, Lehman Brothers International (Europe) ("LBIE"), will deal with you when carrying on business with you. These terms of business (including the cover letter) together with any

> Annex or supplementary set of terms constitute a legally binding agreement between us (the "Terms"). These Terms supersede any previous version of terms and conditions between us on the same subject matter."

Clause 3, headed ADMINISTRATION OF ACCOUNTS, contains four sub-clauses (A) to (D). Sub-clause (D) headed CUSTODY OF YOUR INVESTMENTS sets out detailed terms as to LBIE's custodianship of its clients' property.

It begins as follows:

> "At your request, we may hold certificates or documents of title to investments on your behalf subject to the Rules and provide such other safe custody services as we may agree. Should we agree to provide such services you may be required to execute a Master Custody Agreement or such other agreement relevant to the custody of assets. Charges, if any, for safe custody services provided under these terms and conditions shall be notified to you in the Master Custody Agreement or separately. We may arrange for safe custody investments to be held outside of the United Kingdom (including, for the avoidance of doubt, outside of the EEA)."

At sub paragraph (c) of sub-clause D headed LIEN there are provisions in very similar but not quite identical form to those found in clause 13 of the MCA. I shall have to return to those provisions in detail when dealing directly with the STB. It is sufficient for present purposes to note that, when aggregated with the sixth paragraph of clause 3(A), it deals with LBIE's security rights over its client's assets in just as much detail as does the MCA.

180. Clause 6, headed REPRESENTATIONS AND WARRANTIES, purports to contain a representation and warranty given by clients at sub-section B(b), to the effect that the client is the beneficial owner of all investments and margin deposited or transferred to LBIE by the client "free from any mortgage, charge, lien or other encumbrance whatsoever, other than Permitted Encumbrances". That phrase is defined in clause 5(B) in terms which would include the charge created by the MCA under the heading (i) "created by or pursuant to … any agreement between you and us".

181. Under clause 14 headed MISCELLANEOUS, sub-clause (B) headed "SUPPLEMENTAL TERMS" provides as follows:

> "These Terms, in addition to any other agreement between us, apply to all business which we carry on with you or on your behalf. Subject to the final sentence of Clause 1(A), these Terms, together with any other agreement between us in respect of the same business, shall be read together and construed as one. Certain of the matters required to be specified by the Rules may be set out in the agreement between us. If and to the extent that these Terms are inconsistent or conflict with any other agreement between us, or to the extent that these Terms

> and any other agreement address the same matters, the terms of that other agreement shall prevail."

182. Issue 10 asks two questions. The first is whether custody and security provisions of the MCA were superseded by those in the STB, so that they ceased to be in force as from 1 November 2007. The second is whether, if so, the security interest created by the MCA was discharged and replaced by the security interest purportedly created by the STB. The second of those questions is of course dependent upon the answer to the first. It is important for three reasons. First, the security provisions of the STB are slightly different from those in the MCA. Secondly, the STB was, unlike the MCA, made within a relevant time preceding LBF's insolvency, within the meaning of section 245. Thirdly, and again unlike the MCA, the STB was not signed by or on behalf of LBF. Since a substantial part of the property of LBF held by LBIE at the date of the Lehman collapse had been received into LBIE's custody before November 2007, the failure to have the STB signed has potentially large consequences under section 53(1)(c), if the charge created by the MCA was discharged.

183. Although Issue 10 is in form a question about the continuation of the security rights created by the MCA, the answer to it depends entirely upon the interpretation and application of the STB. I have endeavoured to extract those provisions of the STB relevant to this question, but to some extent my answers are affected by my conclusions on various issues yet to be addressed about the meaning and effect of the STB, such as whether the security rights which it purports to create are in the nature of a lien, charge or some other purely contractual right. For brevity, I will merely say at this stage that I have concluded (for reasons set out in more detail later in this judgment) that the security rights conferred on LBIE by the STB are in the nature of a floating charge, but do not constitute a security financial collateral arrangement within the meaning of the FCARs.

184. For their own tactical reasons, the parties aligned themselves differently in relation to this issue than to most of the others. The only proponent of the case that the STB superseded the MCA was Mr Salter for LBF. LBI aligned itself with LBIE and 314 CA in advancing the case that, pursuant to the last sentence of clause 14(B) of the STB, the MCA was to be treated as prevailing over the custody and security provisions of the STB.

185. The difficulty in resolving this issue arises from the apparent conflict between the last sentence of clause 1(A) which provides that the STB supersedes any previous version of terms and conditions between the parties on the same subject matter, the second sentence of clause 14(B) which provides that the STB together with any other agreement shall be read and construed as one and the final sentence of clause 14(B) which provides that inconsistency or conflict between the STB and any other agreement shall be resolved in favour of the other agreement, and that where the STB and the other agreement address the same matters, the other agreement shall prevail. While it is clear that the second sentence of clause 14(B) is to be read subject to clause 1(A), the same cannot clearly be said of the last part of clause 14(B) and, even if it was, the two appear hopelessly in conflict with each other, at least at first sight.

186. Some assistance may be derived from clause 3(D), which appears to suggest that custody services may not adequately be covered by the STB, and calls for the making of a specific custody agreement between the parties. Mr Salter submitted that this

showed that any previous custody agreement was to be treated as superseded pursuant to clause 1(A), whereas any subsequent custody agreement made pursuant to the invitation in clause 3(D) would prevail over the STB pursuant to clause 14(B).

187. Mr Milligan's submission (supported by counsel for the other parties) was that the only purpose and effect of the last sentence of clause 1(A) was that the STB should supersede earlier versions of general terms and conditions, the intention being that, as stated in the last sentence of clause 14(B), bespoke agreements about specific matters should prevail over the more general terms and conditions in the STB. Clause 3(D) merely demonstrated that custody was a specific matter which would, in the absence of any existing custody agreement between the parties, need to be the subject of a bespoke custody agreement.

188. In my judgment Mr Milligan's submission is to be preferred. My reasons follow. First, there is a real difference between general terms and conditions (such as the STB) and bespoke agreements about particular services, such as the MCA. This difference is reflected both in the phrase "previous version of terms and conditions" in clause 1(A) and in the warning in clause 3(D) of the likelihood that, if custody services were to be provided, a bespoke Master Custody Agreement would be needed between the parties. That warning is, of course, primarily addressed to clients for whom custody services have not previously been provided. For a client like LBF, for whom LBIE have been providing custody services for well over a decade, it would be surprising if the STB was effective there and then to bring to an end the terms of the existing MCA which had regulated the provision of those custody services since 2003, leaving the period until the making of a new MCA to be governed merely by the general terms as to custody set out in the STB.

189. Secondly, the terms of the MCA are in certain respects inconsistent with those of the STB both in relation to custody and in relation to the provisions for security. In particular, the STB makes different provision as to the relationship between LBIE's right to security and the client's right to the immediate delivery-up on demand of property held in custody. There is in particular no replica in the STB of the last sentence of clause 9 of the MCA. Furthermore, on any view, the MCA and the STB are agreements between the parties which address the same matters, namely custody and security, within the meaning of the last sentence of clause 14(B) which is not itself made subject to the final sentence of clause 1(A). Mr Salter submitted that the last sentence of clause 14(B) should be read as applying only to agreements subsequently made but, as Mr Milligan pointed out, a subsequent agreement would automatically prevail over an early agreement, to the extent that it was inconsistent with it, so that the last sentence would therefore be otiose.

190. In my judgment the reasonable and commercial resolution of the prima facie inconsistency between clause 1(A) and clause 14(B) of the STB is that, in relation to custody and security, the STB was designed to provide an immediate contractual framework for new clients with whom no existing custody agreement had been made, but not to displace bespoke custody agreements like the MCA already in place and in operation between the parties.

191. On that analysis, the second part of issue 10 does not arise. But if I were wrong about my answer to the first part, I would nonetheless have concluded that the floating charge created by the MCA was not discharged and replaced by a purported new

charge upon the coming into effect of the STB on 1 November 2007. At the highest, the STB might have been interpreted as giving rise to an agreed amendment of that charge. I would regard a conclusion that the parties consciously discharged a four year old floating charge and replaced it with a fresh one on similar terms as verging on commercial absurdity because of the obvious scope for loss of priority which LBIE would suffer against any other creditors obtaining charges from the same client (in this case LBF) in the meantime. It is to be borne in mind that the question whether any such discharge or substitution was intended is, insofar as it is a question of interpretation of the STB, one which would arise when those terms were used by LBIE with any of its clients on the street, who or which might well wish to grant security to other creditors, even if LBIE's affiliates, such as LBF, did not. It is in that context of no consequence that LBIE did not register its floating charge, created by MCA in 2003, against LBF since, by common consent, no such registration was required in the context of a company neither incorporated nor having a place of business in the UK. Accordingly, issue 10 is to be answered in the negative.

Issue 11: Are the words "any Lehman Brothers entity" which appear in clause 13 sufficiently certain for the purposes of construing clause 13 or should they be disregarded?

192. The ambit of this issue needs briefly to be explained. It arises at two levels. The first is whether for the purposes of a contractual analysis between LBIE and LBF the phrase "any Lehman Brothers entity" is so uncertain as to preclude the existence of a security right in LBIE enforceable in respect of debts owed by LBF to any entity other than LBIE itself. The second question is whether the same phrase is so uncertain as to deprive any supposed trust or fiduciary obligation of LBIE of legal validity due to uncertainty as to the class of intended beneficiaries. At the contractual level, the question addresses the familiar problem that businessmen commonly use definitions which, although workable for most of the time and in most circumstances, may have fuzzy edges. At the level of trusts or fiduciary obligation, the question is a technical one, to which the answer lies in an analysis of the well-known, but infrequently referred to, decisions of the House of Lords in *Re Gulbenkian's Settlements* [1970] AC 508 and *McPhail v Doulton* [1971] AC 424. Since I have concluded (for reasons set out later in this judgment) that the MCA gives rise to no trust or fiduciary relationship between LBIE and its affiliates in relation to the security created by clause 13, the second part of this issue does not strictly arise but I will at the parties' request nonetheless deal with it briefly.

193. It is no part of the court's task (or the parties' submissions) that, if persuaded that the phrase has sufficient certainty, I should identify every entity to which it refers, or even deal with the question whether any particular entity falls inside or outside the class. The question is simply whether the phrase has, or lacks, sufficient certainty for the purposes for which it has been used.

194. Taking contractual uncertainty first, Mr Salter submitted that the phrase "any Lehman Brothers entity" failed for uncertainty in two respects. First, it was uncertain to which entities the phrase referred, and it lacked any sufficient formula to enable that question to be answered in relation to all potential candidates. Secondly, it was uncertain as to the date upon which the question whether an entity was a Lehman Brothers entity should be addressed.

195. The court has a well established reluctance to strike down what were obviously intended to be legally enforceable commercial contracts, on grounds of supposed uncertainty: see *Durham Tees Valley Airport Ltd v BMI Baby Ltd and anr* [2010] EWCA Civ 485 per Patten LJ at paragraph 54 and Toulson LJ at paragraph 88. In *Scammell v Dicker* [2005] EWCA Civ 405, at paragraph 30, Rix LJ said:

> "Parties are always disagreeing about the contracts which they make. They take those arguments, if necessary, to the courts, or to arbitration, for their resolution: and sometimes the resolution is very difficult indeed to arrive at. That is equally true of disputes as to the meaning of contracts and of disputes as to the application of contracts to the facts and of disputes as to the proper understanding of the facts. None of that makes a contract uncertain. For that to occur – and it very rarely occurs – it has to be legally or practically impossible to give the parties' agreement any sensible content."

196. In *Hillas v Arcos* (1932) 147 LT 503, at page 504 Lord Wright said:

> "Businessmen often record the most important agreements in crude and summary fashion; modes of expression sufficient and clear to them in the course of their business may appear to those unfamiliar with the business far from complete or precise. It is accordingly the duty of the court to construe such documents fairly and broadly, without being too astute or subtle in finding defects, but, on the contrary, the court should seek to apply the old maxim of English law *verba ita sunt intelligenda ut res magis valeat quam pereat.*"

197. The phrase "any Lehman Brothers entity" in clause 13 of the MCA is a classic example of the crude and summary expression of an important provision in a commercial agreement. Furthermore the MCA gives no express guidance as to the date upon which the phrase is to be applied. As to the latter, it seems to me obvious that the relevant date is the date upon which LBIE seeks to enforce the clause 13 charge (or other security right), and claims to do so in respect of debts owed by the client (here, but not necessarily, LBF) to some other person who is claimed to be a Lehman Brothers entity. That date is the relevant date because the purpose of the clause 13 security is to operate as a continuing security for the repayment of debts incurred by the client in dealings with both LBIE and other entities within the Lehman Brothers Group. There would be no reason to exclude a debt incurred by the client to an entity which had only been recently formed or acquired within the group merely because it did not exist at the time of the creation of the floating security. In any event, whether that answer be obvious or not, there is no conceptual impossibility occasioned by the need to find an appropriate test date. The identification of the date is simply a matter of interpretation.

198. In my judgment the same is true of the supposed difficulty in ascertaining, on the test date, what legal persons are to be regarded as falling within that definition. In the real world, the question would arise as a concrete issue, namely whether a debt owed to a particular legal person was within the confines of the security. That legal person would be identified by LBIE when seeking to enforce its security. In most cases, the

answer to the question whether the creditor was a Lehman Brothers entity would be obvious. It is possible that in a minority of cases the answer might be difficult, but its resolution would, again, be a matter for the interpretation of the MCA and its application to particular facts about the entity in question. It would give no rise to no impossibility or conceptual uncertainty, however difficult it might occasionally be to resolve in practice.

199. It is simply wrong in my judgment to conclude, as Mr Salter suggests, merely because there may be a number of regulatory or company law definitions of group, subsidiary, associated or connected company available to choose from as the intended meaning of Lehman Brothers entity that any question of certainty arises. It is, or maybe, a question of difficulty but not of certainty.

200. Turning to the more technical question whether the phrase "any Lehman Brothers entity" sufficiently identifies the beneficiaries of a supposed trust or fiduciary obligation in relation to LBIE's clause 13 security rights, the relevant test in the light of the *McPhail v Doulton* is whether it can be said with certainty that any given person is or is not a member of the beneficial class: see per Lord Wilberforce at [1971] AC 424, at 456 C.

201. In the ordinary course of events, and assuming the existence of a trust or fiduciary power to enforce the clause 13 security for the benefit of affiliates, the certainty question would arise upon a request for enforcement by a person claiming to be a Lehman Brothers entity. In the overwhelming majority of cases, that question would again give rise to no difficulty. In some cases the answer might be difficult, but would, as with the application of the test for contractual certainty, be a matter of interpretation and application to the facts of a definition which is not conceptually uncertain. The difference between conceptual uncertainty and practical difficulties in application is as relevant to the question whether trusts and fiduciary powers are void for uncertainty as it is in relation to contracts: see again per Lord Wilberforce in *McPhail v Doulton* at page 457.

202. Issue 11 is therefore to be answered in the negative.

Issue 12: Does clause 13 of the LBF MCA give rise to a trust or fiduciary power in favour of "Lehman Brothers entities"?

203. As set out earlier in this judgment, I have concluded that this question also ought to be answered in the negative. I now give my reasons.

204. At the stage of skeleton arguments, it appeared to be common ground that the question whether a trust or fiduciary obligation in favour of the affiliates ought to be implied in clause 13 of the MCA (no such obligation being expressed) depended, like the implication of any implied term, upon a demonstration of necessity. In his oral submissions Mr Snowden (the only proponent of a trust or fiduciary obligation) tended to backtrack on that requirement, suggesting that the court adopted a more neutral attitude to the implication of a trust, even in a business agreement such as the MCA.

205. In my judgment the concession in 314 CA's skeleton argument (at paragraph 94) that a trust will be implied only where necessary was correctly made. It was based upon

the following passage in Underhill and Hayton's Law relating to Trusts and Trustees (17th Ed.), at paragraph 8.1:

> "No technical expressions are necessary for the creation of an express trust, which may be created without the settlor being aware of this, so long as he intends to create a state of affairs that can only be accomplished if he creates a trust."

That statement was intended to be applicable to trusts generally, and probably mainly to traditional family trusts. I would add that, in the business context, it is well recognised that the unthinking identification, whether by implication or otherwise, of a trust relationship between business entities runs the serious risk of producing results contrary to the parties' intentions and contrary to ordinary business commonsense. Leaving aside terms implied by law, it is beyond question that a necessity test is invariably applied to the implication of terms into a written contract. In relation to contracts between businessmen, it is usually referred to as a business efficacy test.

206. I consider that the attempt to imply a trust or other fiduciary obligation owed by LBIE to its affiliates in relation to the charge or security interest created by clause 13 of the MCA fails the business efficacy test, and by a wide margin. Mr Snowden submitted that the implication was necessary because, in the absence of it, LBIE would be free to exercise, or refuse to exercise, its security rights for the purpose of discharging debts owed to its affiliates in its own interests, rather than in theirs, and free even to auction those rights, or hold affiliates to ransom in respect of their exercise. That submission needs to be addressed in the context of the enforcement scenario which may reasonably have been in the contemplation of the parties to the MCA at the time when it was made.

207. Ordinarily, the MCA was designed as a framework for the provision of custody services by LBIE to its street clients, and the security rights in clause 13 were directed to the risk of client insolvency, so as to protect both LBIE and any other entities within the Lehman group which, in the course of the provision of the group's services to that client, became its creditors. The question whether, and if so to what extent, to exercise those security rights against a client would ordinarily be a matter for LBIE's business judgment, having regard to the likely effect upon its business relationship with its client, but having due regard to the interests of its (LBIE's) stakeholders, like any other business decision by a corporate entity. For as long as the Lehman group remained a going concern, the interests of its affiliates in having their debts discharged by exercise of the clause 13 security would, *quoad* LBIE, be represented by the interests of LBIE's ultimate stakeholder, LBHI, since it would not only be LBIE's parent, but the ultimate parent of any relevant affiliate creditor within the group.

208. In fact, the Lehman group's business was not generally managed on a company by company basis, but on a product by product basis, so that the interests of the group would be in the forefront of the minds of relevant business managers when deciding whether, and if so to what extent, to exercise rights over the property of street clients, conferred by contracts between those clients and any particular Lehman group company.

209. In the context of the ordinary management of the Lehman group's affairs while a going concern, it would in my view be absurd to imply some relationship of trust or fiduciary duty between LBIE and its affiliates in relation to the exercise of the clause 13 security rights. Quite apart from the fact that there is no expression in the MCA of the terms of that trust or fiduciary obligation, for example in terms of any scheme of priorities as between LBIE and its affiliates in the deployment of the security rights, the very existence of ill-defined fiduciary obligations would be an impediment to the sensible and practical making of business decisions in relation to the exercise of the rights in clause 13.

210. Mr Snowden's primary submission (again based upon the absence of any express provisions to the contrary) was that LBIE and its affiliates should be taken to be equal beneficiaries in relation to the clause 13 security rights, each with equal rights to demand enforcement, and an equal share in the fruits thereof. Again, that strikes me as an impossible contention. It would require LBIE to maintain a constant watch upon the day to day account balances between each of its clients (the subject of an MCA in this standard form) and each of its many affiliates. It would enable an affiliate with a modest debt to demand enforcement in circumstances where to do so would gravely prejudice a continuing business relationship either between LBIE and the client in question, or between some other affiliate and the same client. It would also be inconsistent with the express terms of the last sentence of clause 9 of the MCA, in which LBIE's right of retention (pending crystallisation) is limited in amount to that necessary to cover its reasonable perception of its exposure to the client, rather than the exposure of any one or more of its affiliates. While the evidence suggests that the group's accounting systems may well have been sufficient to enable LBIE to carry out the sort of monitoring necessary to give practical effect to the existence of the supposed fiduciary obligation, the evidence does not suggest that this was actually done, either before or after the making of the MCA.

211. It makes no real difference to this analysis that this MCA was made between LBIE and LBF, rather than between LBIE and its street clients. It is plain that no conscious thought was given to the implications of the use between two Lehman entities of a standard form of agreement designed for use between a Lehman entity and street clients. Nor does the fact that the client in this context was LBF in any way displace what seems to me the obvious intention that ordinary business judgments, taking into account the interests of LBIE's stakeholders, should regulate the nature and extent of the exploitation against the client of the security rights in clause 13.

212. Mr Snowden submitted that the analysis is very different once the Lehman group has collapsed, in the sense that the office-holders now responsible for the exploitation of LBIE's rights no longer have the interests of the group, as represented by LBIE's ultimate parent LBHI, as governing or even significant criteria in their decision making, the interests of LBIE's internal group stakeholders having been entirely replaced by the interests of its unsecured creditors. That may be true, but it comes nowhere near justifying recourse to a group collapse scenario as the context in which to address the issue of business efficacy or necessity. In terms of business intent, the MCA was framed in a context in which the possibility of a collapse of the entire Lehman group cannot have been a significant feature in the contemplation of its draftsman. Nor is a conclusion that LBIE is now free to exercise its clause 13 rights against LBF by reference to its perception of the interests of its unsecured creditors

unworkable. All that has happened is that LBIE's stakeholders have changed, so that its property, including its clause 13 rights under the MCA, must now in accordance with the UK insolvency scheme be exercised for the benefit of its new stakeholders. An express provision that, in such circumstances, LBIE should for the first time become a trustee of its clause 13 rights, whereas it had previously owned them beneficially, would give rise to serious questions under the *British Eagle* principle. The notion that, purely because of difficulties arising on insolvency, such a trust should be identified by implication, as arising from the moment when the MCA was made, seems to me unarguable.

213. I have not in the above analysis left out of account the fact that, in a separate agreement made between LBIE and LBF, namely the 2007 IPBA, an express trust of comparable security rights was created, coupled with a detailed statement of the priorities between LBIE and its affiliates in relation to the fruits of their exercise. All that shows is that the parties to such agreements could if they wish create trusts or fiduciary obligations of the type in issue. The fact that LBIE and LBF could and did do so when they wished to is by no means a basis for implying similar trusts or fiduciary obligations into agreements between them, in which they chose apparently not to do so in express terms.

Issue 13: If the answer to 12 is yes, what are the terms of that trust or fiduciary power, including as to the priorities which apply as between LBIE and the "Lehman Brothers entities" and as between "Lehman Brothers entities" inter se? Did LBIE have the right to deal with the assets subject to the trust having regard only to its own interests or was it required to have regard to the interests of the beneficiaries? If the former, has it lost that right and, if so, how and upon the meaning of what event?

214. My conclusion that there are to be implied no trusts or fiduciary obligations as between LBIE and its affiliates in relation to the security rights created by clause 13 of the MCA makes it strictly unnecessary to consider this issue. Notwithstanding the parties' general invitation that I should nonetheless resolve unnecessary issues by giving answers and brief reasons, I have found it impossible to do so in relation to Issue 13. I have been so completely un-persuaded by the submission that any trust or fiduciary obligation should be implied, that the task of setting out the detail thereof, on the basis that my conclusion to that effect is wrong, requires an exercise in speculation on my part which would be best left to any higher court which took a different view to the answer to Issue 12.

Issue 14: Does clause 13 of the MCA confer rights on "Lehman Brothers entities" by virtue of the Contract (Rights of Third Parties) Act 1999?

215. It is now agreed that this question should be answered in the negative, and that reasons are unnecessary.

LBF STB (and certain issues pertaining to LBI)

216. I have already set out those provisions of the STB relevant to the question whether it superseded the MCA as between LBIE and LBF in relation to custody and security, and concluded that it did not. I am nonetheless asked to deal separately with the issues relating to the STB, which largely mirror the same issues relating to the MCA.

This is not merely because a different view may be taken by a higher court on the question of supersession, but because the administrators are concerned that there are or may be security rights against other entities than LBF governed purely by agreements in the same form as the STB. Provisions of the STB creating and relevant to security rights are as follows:

Under clause 3 headed Administration of Accounts, and sub-clause A, headed BASIS OF CHARGES, the sixth (un-numbered) paragraph provides as follows:

> "Unless we expressly agree with you in writing to the contrary, all payments and deliveries between us shall be made on a net basis and we may not be obliged to deliver or make payment to you or both (as the case maybe) unless and until you perform your obligations to us."

Section 3(D)(c) headed LIEN provides:

> "Subject to clauses 7 to 9, we shall have a general lien on all safe custody investments held by us under these Terms until the satisfaction of all liabilities and obligations of yours (whether actual or contingent) owed to us or any Lehman Brothers entity. In the event of your failure to discharge any of such liabilities and obligations when due, such non-performance remaining un-remedied for a period of 3 days after notification by us to yourself, we shall be entitled to sell, in a commercially reasonable manner, using our reasonable endeavours to obtain the best result in respect of any such sale, after notice to you, or otherwise realise any such safe custody investment and to apply any monies from time to time deposited with us, and the proceeds of such sale or realisation to the satisfaction of such liabilities and obligations. For the purpose of such application we may purchase with any monies standing to the credit of your account such other currencies and at such rate(s) of exchange as may be necessary to effect such application."

217. Clauses 7 to 9 deal respectively with events of default, consequences of events of default and realisation of security. Clause 8(A)(b) enables LBIE to accelerate future liabilities upon an event of default. Clause 8(N) enables LBIE to combine accounts and set off in terms extended to the client's liability to its associated companies. Otherwise, nothing of significance for present purposes is to be found in those provisions.

Issue 15: What is the nature of the security interest created by clause 3(D)(c) of the LBF STB and described as a "general lien"?

a) Is it a general lien and if so is it capable of applying to intangible property?

b) Or is it properly characterised as a charge (which by its nature would bite on both tangible and intangible property)?

c) Or is it to be characterised as some other form of security interest that is capable of applying to both tangible and intangible property?

218. Clause 3(D)(c) of the STB is strikingly similar to the terms of clause 13 of the MCA. The only significant difference in the security rights created by the two agreements is that there is no equivalent in the STB of the final sentence of clause 9 of the MCA, giving LBIE a qualified right of retainer pending crystallisation, in respect of its reasonable estimate of its own exposure to the client. Conversely there is nothing in the MCA equivalent to the sixth paragraph of clause 3(A) of the STB which, it was submitted, gave LBIE a right of retainer extending to all of its client's property, against discharge of current (rather than future or contingent) liabilities to LBIE. I shall return to the meaning of the sixth paragraph of clause 3(A) of the STB in due course. For present purposes it makes no difference to the answer to Issue 15, which is that the STB creates a charge rather than a lien or other form of security right over all the client's property within the meaning of "safe custody investments" under clause 3(D)(c).

219. Mr Salter submitted that the phrase "safe custody investments" in clause 3(D)(c) excluded cash because the phrase was a defined term under the FSA Rules (in the Glossary to the FSA Handbook), and clause 14 (T) provides that words and expressions in the STB shall have the same meaning as defined expressions in the Rules, unless otherwise defined in the STB. Mr Milligan initially disputed that, because the word 'investments' is specifically defined in the STB so as to include cash.

220. It is unnecessary for me to resolve that question because on any view clause 3(D)(c) of the STB contains a right to apply monies deposited and the proceeds of the sale or realisation of investments: so that there exists a charge in sufficient terms to cover money held in custody by LBIE for its client, regardless whether money is, as such, a safe custody investment.

Issues 16, 17 and 18

221. It is unnecessary for me either to set out, or to deal with, these issues in full. They are framed in identical terms to Issues 2, 3 and 4, in relation to the MCA. There are no differences in the expression or nature of the security rights created as between the two agreements sufficient to give rise to any different answers to those questions, or even to any serious argument that the answers should be different. Furthermore, these issues only arise (in relation to the relationship between LBIE and LBF) if I am wrong in my conclusion, under Issue 10, that the STB did not in fact create any new charge, replacing the charge created by the MCA.

Issue 19: Charge on book debts

222. As with Issue 5 in relation to the MCA, it is now agreed that I need not deal with this question in relation to the STB.

Issue 20: Applicability of the FCARs

223. It is unnecessary to set out the FCARs questions in full. They replicate the questions asked in relation to the MCA under Issue 6. Although formally included, no

retroactivity issue arises, because the STB was entered into long after the coming into force of the FCARs in December 2003. If there exist any agreements creating security rights in favour of LBIE in the STB form, made prior to December 2003, then my answer to Issue 6(a) applies equally to Issue 20(a).

224. Leaving aside retroactivity I can see no reason to treat the security rights created by the STB as a better candidate for qualification as a security financial collateral arrangement than those created by the MCA. On the contrary, I consider that in one important respect, the security rights created by the STB are a poorer candidate. This is because of the absence of any right, pending crystallisation, to retain safe custody investments (or other property held as custodian) against LBIE's reasonable estimate of its exposure to the client, in relation to future or contingent liabilities. Like the final sentence of clause 9 of the MCA, the STB affords no right of retainer in respect of the client's debts to LBIE's affiliates. Thus the possession or control test is clearly failed.

225. Accordingly, although the FCARs were clearly in force when the security rights were created pursuant to this version of the STB, in 2007, the rights thereby created nonetheless fell outside the definition of a security financial collateral arrangement.

Issue 21: Section 53(1)(c) of the Law of Property Act 1925

226. Issue 21 contains a concealed sub-issue which arises if, contrary to my conclusion, a higher court were to conclude that, generally speaking, the STB superseded the MCA as between LBIE and LBF, and created a new charge in place of the charge created by the MCA in 2003. Mr Milligan pointed out that the definition of disposition for the purposes of section 53 includes a release: see section 205(1)(ii). If the unsigned STB was the only basis for a claim that the charge created by the MCA had been released, then it would, by parity of reasoning, also fall foul of section 53(1)(c). I consider that submission to be incorrect. The STB was unsigned by LBF, but its covering letter (to which it was annexed) was signed by LBIE. For the purposes of the release of a charge, section 53 requires signature by the proprietor of the charge, rather than by its original grantor.

227. Apart from that, my reasoning and answers to this issue are the same as those in relation to Issue 7 and need no further elaboration.

Issue 22: Section 245 of the Insolvency Act 1986

228. This issue replicates Issue 8 in relation to the MCA. The STB was plainly made within a relevant time for the purposes of section 245 such that, unless supported by the requisite type of value, the floating charge created by the STB is invalid as a result of the bankruptcy of LBF. That much was common ground. Mr Milligan submitted that if (contrary to my conclusion) the STB had superseded the MCA and given rise to a new charge in substitution for the earlier charge, then the release of the earlier charge would have been sufficient value for the purposes of section 245(2) to avoid invalidity. I disagree. 'Value' is precisely defined in section 245(2)(a)(b) and (c), in terms which exclude the value flowing to the chargor arising from the simultaneous release of an earlier charge.

229. Since this issue arises only if my conclusions on other issues (such as supersession and section 53) are wrong, I need express my reasons in no greater detail.

Issues 23 to 26

230. All these issues replicate the equivalent issues which I have already dealt with in relation to the MCA, and I need say nothing further about either the answers to them, or my reasons.

Issue 27: Does clause 3(D)(c) of the STB confer rights on other Affiliates by virtue of the Contract (Rights of Third Parties) Act 1999?

231. This is I think the only issue which relates solely to the STB. Clause 14 (T)(a) provides that:

> "'associated companies' shall mean Lehman Brothers Holdings Inc. and each company with which it is affiliated and which conducts investment business (including, for the avoidance of doubt, LBIE and LBEL), all of which are connected with us for the purposes of the Rules and all of which (together with our and their respective directors, employees and agents) shall be entitled to rely upon and enforce the provision of these Terms where appropriate by virtue of the Contracts (Rights of Third Parties) Act 1999 (UK). …"

232. Section 1 of the 1999 Act provides (so far as is relevant) as follows:

> " (1) Subject to the provisions of this Act, a person who is not a party to a contract (a 'third party') may in his own right enforce a term of the contract if –
>
> a) The contract expressly provides that he may, or
>
> b) Subject to subsection (2), the term purports to confer a benefit on him.
>
> (2) Sub-section (1)(b) does not apply if on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party."

233. Clause 14(T)(a) of the STB is entirely unspecific as to the terms intended to be enforceable by third parties. The third parties are those within the defined term "associated companies". This phrase is used in various places in the STB, such as clause 8(A), clause 14(G) and clause 14(J), but it is not the phrase used in clause 3(D)(c) for the purposes of identifying the liabilities and obligations of the client capable of being discharged by exercise of the security rights.

234. That, albeit linguistic, distinction provides a useful clue to what I regard as the purpose of the reference to the 1999 Act in clause 14(T)(a). The intention is that associated companies should be entitled to "rely upon and enforce" the provisions of the STB "where appropriate". It applies where, but only where, the term in question is one which it would be appropriate for an associated company to enforce, or to rely

upon. Thus in clause 14(G) it would be appropriate for associated companies to rely upon the exclusion of liability there set out. Similarly, in clause 14(J) it would be appropriate for associated companies to rely upon (in the sense of using as a defence) the permission given for the transmission of information to them by LBIE, and in relation to the transmission of information by associated companies to regulatory bodies.

235. Turning to clause 3(D)(c), the rights of sale, and of appropriation of the proceeds of sale and of deposited monies, are unambiguously conferred on LBIE rather than upon associated companies, or even other Lehman Brothers entities. The reference to Lehman Brothers entities is merely the means whereby the sub-clause identifies the liabilities of the client for the discharge of which its safe custody investments and other deposited monies are to stand as security.

236. Furthermore, it would in my judgment be inappropriate to interpret the invocation of the 1999 Act as permitting parallel enforcement of the clause 3(D)(c) security rights, not only by LBIE but separately by any relevant creditor affiliate. Even though the absence of any provision for crystallisation in the event of a default in the performance of the client's obligations to an affiliate (rather than to LBIE) may mean that there is no risk of enforcement by an affiliate prior to crystallisation, nonetheless parallel enforcement of a single charge at the instance of a potentially wide range of different creditors strikes me as an inherently un-businesslike concept, and one which the court should not conclude was intended, unless driven by the language to do so. For the reasons given, the language used does not point in that direction at all.

237. I make it clear that I have reached this conclusion independently of my conclusion that the STB creates no trust or fiduciary obligation upon LBIE for the enforcement of its security rights for the benefit of its affiliates. If, as I have concluded, it does not, then there is no reason to conclude that the parties achieved a similar result by the inclusion, by a side-wind, of an entirely uncontrolled right of enforcement available to each creditor affiliate. If, contrary to my view, such a trust or fiduciary obligation is created, then enforcement would ordinarily be carried out by LBIE as trustee or fiduciary. Failure to perform that fiduciary duty would be actionable by any affiliate beneficiary, by proceedings directed to requiring LBIE to perform its duty, or seeking its replacement as trustee, rather than by proceedings directly against the client debtor, or against its assets.

238. Finally, in the context of an agreement in which the security rights appear as part of the terms as to custody, I consider it again to be unlikely that the parties would have intended that anyone other than the custodian of the security property would be enabled to exercise security rights in relation to it. That is not to say that custody is an essential requisite for the creation of security. In relation to a charge it is not. Nonetheless the custody of the security property is plainly sufficient to place the custodian in a uniquely favourable position for enforcement, ahead of any competing supposed beneficiary of the security.

239. For all those reasons I would answer Issue 27 in the negative.

Postscript

240. Issues 28 to 37 relate to the 2007 IPBA, about which the parties are now agreed that I need make no determination. Issues 38 to 42 are no longer in dispute. Issues 43 to 49 are, by agreement, to be left for determination otherwise than in these proceedings.

241. Following the conclusion of the hearing of this application I was notified that a conditional settlement of litigation issues between some of the parties had been reached. Nonetheless the parties agreed that I should nonetheless give judgment on the above issues, including those not strictly necessary to my decision.

242. I shall therefore give directions and, if necessary, make declarations in terms of the answers to Issues 1 to 27 in accordance with the relevant parts of this judgment. If the form of an appropriate Order cannot be agreed, I will hear submissions in relation to it, on a date to be arranged.