WHAT MAKES AN ENTITY A "FINANCIAL INSTITUTION"?

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The English High Court judgment in *Olympia Securities Commercial Plc (In Administration) (1)* has resolved the uncertainty surrounding the term "financial institution" in transfer provisions. The Court has given clear direction as to what constitutes a "financial institution" for the purposes of these clauses. Although only a first instance judgment, the decision will be welcomed by the financial sector as providing important clarity on a commonly used term.

The ability to assign rights, or novate rights and obligations, under an agreement to a third party is central to ensuring that the transaction embodied in that agreement is tradeable on the secondary market, and thus occupies an important role in the financial sector. In particular, the trading of distressed debt assists in the management of lender risk by allowing primary lenders to recoup the majority (or at least a significant portion) of a risky debt more quickly and with less uncertainty than would be the case if they waited in the hope of a greater recovery at a later date (e.g. through enforcement). It is also increasingly common for banks to seek to sell out their positions in relation to entire loan portfolios in order to restructure their business.

As a result, facility agreements invariably include specific provisions dealing with the lender(s)' rights to sell their position to a third party, including pre-approving certain types of purchaser. These provisions are intended to provide certainty and prevent borrowers from obstructing such sales, and generally they are effective at doing so.

However, they can also lead to disputes where it is unclear whether the proposed purchaser falls within their terms.

Facility agreements which allow for transfers to "banks or other financial institutions" are one example where such disputes have arisen. These disputes arise as a result of the uncertainty as to what constitutes a "financial institution" for the purposes of these provisions. In particular, it has been unclear whether a special purpose vehicle formed for the sole purpose of the transfer will be acceptable.

BACKGROUND

The standard position in English law is that, subject to any contractual restriction, parties are free to assign their rights under an agreement at will, but may only fully transfer their position under an agreement (i.e. both their rights and their obligations) by way of novation. Novation requires the agreement of all parties to the transaction. The distinction between assignment and novation is therefore significant.

Since there is no automatic right for a party to novate an agreement, it is common practice in transactions where it is anticipated that one party may wish to sell its position, such as in financing arrangements, for the parties to contractually vary their rights in this regard. In the case of facility agreements, it will often be agreed that the lender(s) can 'transfer' both their rights and obligations to specified classes of third party without the borrower's consent. In exchange, the borrower's consent will be required for any 'transfer' to parties that do not fall within the pre-approved classes of third party, whether by way of novation or assignment.

The effect is to make it easier for the bank to sell its position in full (i.e. both its rights and its obligations) in exchange for accepting a degree of restriction on its ability to assign its rights. Although primarily a benefit for the bank, the arrangement affords the borrower a greater degree of control over who has rights against them than they would otherwise have. This can be useful where, for example, a borrower wishes to avoid the transfer of its financing to more aggressive counterparties.

TRANSFERS TO "FINANCIAL INSTITUTIONS"

It is thus common for facility agreements to permit 'transfers' of the lender(s) position to "banks or other financial institutions". Indeed, prior to 2001, the LMA standard form facility agreement included such a provision.

However, the term "financial institutions" is not typically defined, and is not a term of art in the financial sector. As a result there has long been uncertainty as to what exactly qualifies a transferee to be considered a "financial institution" and in 2001 the LMA revised the wording to provide a broader definition of approved third parties for just this reason.

The question of what constitutes a "financial institution" was partly addressed by the Court of Appeal in *Argo Fund Ltd v Essar Steel Ltd (2)*. In that case the Court of Appeal held that a hedge fund was a "financial institution". However, the outer limits of what can be considered to be a "financial institution" remained undecided.

The Court of Appeal provided various obiter comments on the point: Lord Justice Auld, giving the majority judgment, stated that it was sufficient for the transferee to be an entity with "a legally recognised form or being, which carries on its business in accordance with the laws of its place of creation and whose business concerns commercial finance." This is a very broad definition, which would encompass everything from substantial hedge funds to companies set up purely for the purpose of purchasing a particular debt.

However, Lord Justice Rix, although agreeing with the conclusion of the majority in relation to hedge funds, gave the following view on what in general might constitute a "financial institution":

"…the essential characteristic of a 'financial institution' is that it provides capital to financial markets… regularly makes, purchases or invests in loans, securities or other financial assets. As such, such institutions are likely to be professional, more or less regulated, and of a certain size. It seems to me that the word "institution" denotes an entity of a certain substance… I would suggest that the only satisfactory way to regard this element is to say that the word is intended to exclude entities which are insubstantial."

It might be argued that Rix LJ's approach represents a narrower view, which could exclude companies set up purely for the purpose of purchasing and holding a debt.

As the Court of Appeal was only required to decide the question of whether a hedge fund specifically qualified as a “financial institution”, it was not necessary for it to decide the point. These comments were therefore strictly obiter, and it remained uncertain as to whether a transfer to a corporate vehicle created for the purpose of purchasing a particular loan would be a transfer to a “financial institution” for the purposes of such clauses.

RE OLYMPIA SECURITIES COMMERCIAL PLC (IN ADMINISTRATION)

However, this question has now been brought before the High Court in *Olympia Securities*.

The administrators of Olympia Securities Commercial Plc (“Olympia”) sought directions in relation to a claim for over £6 million following the early termination of a series of interest rate swaps and whether those swaps were secured on a debenture which had been assigned to WDW 3 Investments Ltd (“WDW”) by Anglo Irish Bank Corporation Ltd (now Irish Bank Resolution Corporation Ltd, “IBRC”) as part of an assignment of IBRC’s rights under a facility agreement with Olympia (the “IBRC Facility”) to WDW.

The IBRC Facility included a provision that “the Lender may… at any time transfer, assign or novate all or any part of the Lender’s rights, benefits or obligations under this agreement to any one or more banks or other financial institutions”. The ultimate parent of Olympia, which was also an unsecured creditor, argued, amongst other things, that WDW, a company with a share capital of £1 which had been incorporated just two weeks before, and solely for the purposes of, the transfer, was not a “financial institution” for the purposes of this clause. It therefore claimed that the transfer was invalid.

Judge Pelling QC held that, as it was part of the majority decision, the test set out by Lord Justice Auld in *Argo Steel* should be applied. He therefore held that, as WDW was a company that was “a legally recognised form … which carrie[d] on its business in accordance with the laws of its place of creation and whose business concerns commercial finance”, it was a “financial institution” for the purposes of the Facility Agreement.

He also rejected arguments that a “non-trading £1 company” could not be considered an institution because:

1. A requirement that a company must have a sufficient degree of capitalisation to be an “institution” would be essentially arbitrary, and that such a requirement would also exclude other corporate forms, such as partnerships, from being “institutions”;
2. The suggestion that a company must be a “trading” company to be an institution “lacks reality” as it essentially requires a prospective transferee company to carry out a nominal transaction before it can be treated as a “financial institution”, regardless of how clearly it otherwise meets the criterion of a financial institution and how “economically insignificant that transaction might be”; and
3. It was not necessary for the company to be regulated beyond the obligation to comply with the laws imposed on such an entity carrying on its business in its place of incorporation (in this case England & Wales).

Judge Pelling QC also noted that if the borrower had wanted greater restrictions on acceptable transferees it could have agreed that in the IBRC Facility.

CONCLUSION

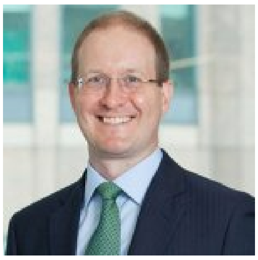
The decision in *Olympia Securities* indicates that, provided it is properly incorporated and operated in accordance with the laws of the place in which it is formed, a corporate entity (or partnership) formed solely for the purposes of receiving the transfer of a lender's position under a loan is a "financial institution" for the purpose of transfer provisions of the sort discussed in this briefing note.

It remains to be seen whether this decision will be appealed. However, in the meantime it will provide comfort for lenders seeking to sell and parties seeking to purchase debts that they can do so through special purpose vehicles without breaching provisions limiting transfers to "banks or other financial institutions".

1 [2017] EWHC 2807 (Ch)

2 [2006] EWCA Civ 241

KEY CONTACT



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