TRAVERS SMITH

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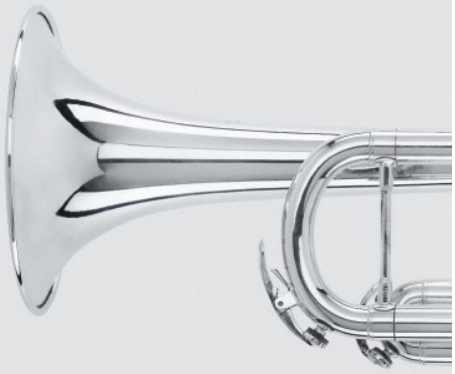

Welcome to the monthly finance bulletin from our banking and corporate recovery department. This issue contains our usual overview of some recent market developments and trends in the finance sector, including a spotlight on shadow banking. Please get in touch if it raises any issues that you would like to discuss.

Jeremy Walsh, Head of Banking and Corporate Recovery Department

Vickers Lite?

The government's white paper on banking reform implements most of the Vickers proposals, but not all of them and Sir John Vickers believes the reforms should have included the proposed higher leverage on ringfenced banks of 4% (rather than 3%). In a move particularly welcomed by HSBC, the white paper also excuses banks from meeting loss-absorbing debt requirements on overseas assets (absent a strong case to the contrary). Derivative products used to hedge interest rate and currency fluctuations for small businesses will also be included within the range of activities capable of being conducted by ring-fenced banks.

Contractual Recourse v Subrogation Rights

In order to prevent unjust enrichment, there are various circumstances in which English law recognises that a person who discharges a debtor's liability to a third party acquires the contractual and property rights of the third party against the debtor. This process of substitution – by way of example, the ability of a paying guarantor to step into the shoes of the original creditor – is known as subrogation.

The recent Court of Appeal decision in *Ibrahim v Barclays Bank PLC and another [2012] EWCA Civ 640* suggests, however, that reliance on subrogation principles rather than recourse through properly drawn contracts may be misplaced.

The case centred on the efforts to rescue the LDV Van manufacturer in 2009. Weststar, a Malaysian company distributing the vans in Asia was under the ownership of Mr Ibrahim. LDV was in difficulty and its directors decided to petition for administration. A rescue plan was implemented quickly. The Department of Business, Enterprise and Regulatory Reform (now known as BIS, then known as BERR) agreed, against Weststar's agreement to purchase the shares in LDV from their Eastern European owners, to guarantee part of LDV's liability to Barclays; LDV agreed to counter-indemnify BERR's liability under the guarantee; UBS issued a standby letter of credit in favour of BERR; and BERR agreed with Barclays under a Realisation Agreement to share in recoveries from LDV until such time as BERR had been repaid in full for any liability incurred under the BERR guarantee. Mr Ibrahim counter-indemnified UBS. BERR therefore had significant contractual recourse, but as Lewison LJ noted "economically, the buck stopped with Mr Ibrahim".

Weststar withdrew from the acquisition. Events of default were triggered. Barclays claimed under the BERR guarantee; BERR claimed under the LDV counter-indemnity; BERR claimed under the UBS LC; and UBS claimed against Mr Ibrahim. Mr Ibrahim argued that he was subrogated to the rights enjoyed by BERR under the LDV counter-indemnity and to the rights enjoyed by BERR under the Realisation Agreement. It was crucial to Mr Ibrahim's argument that the payment by UBS to BERR did not discharge the debt due under the counter-indemnity from LDV to BERR. This was the key issue because the Realisation Agreement was in terms that BERR ceased to be entitled to any share of Barclays recoveries once the guarantor liabilities assumed by BERR had been paid and discharged in full. At first instance, Ibrahim's claim failed, the court holding that LDV's counter-indemnity obligations to BERR were discharged by the UBS payment.

The Court of Appeal (CA) was asked to reconsider this point. The case ceased to be clouded by technical subrogation issues because in 2012, BERR assigned its rights under the Realisation Agreement and the LDV counter-indemnity to Mr Ibrahim. The CA allowed the amendment to pleading in the interests of justice, but still had to consider the same point. If the UBS payment discharged the LDV obligation, nothing was due under the assigned LDV counter-indemnity or Realisation Agreement. The specific terms of the UBS LC were that a payment would be made against BERR certification that payment "represents and covers the unpaid sums" due to BERR by LDV. LDV had also by the

Spotlight on… Shadow Banking

Michel Barnier, the European Commissioner for Internal Market and Services, has said that regulating the shadow banking industry is one of his main priorities for the coming year. The G20 Leaders are due to make recommendations on shadow banking at the end of this year and the Financial Stability Board is to liaise with the national supervisory bodies with respect to regulatory action shortly thereafter.

But how do you regulate something so nebulous? Lord Turner, Chairman of the FSA noted just a few weeks ago, "the difficulty starts with the definition" and the first question asked of its constituents in the EU Green Paper issued in March 2012 was "do you agree with [our] proposed definition of shadow banking?". The recently published Deloitte Shadow Banking Index provides a brief definition of "market, non-bank funded, credit intermediation activities" and identifies, in close parallel with the EU Green Paper, relevant entities and activities as including money market mutual funds; asset-backed commercial paper conduits; asset-backed securities; collateralised debt obligations and repos.

The concern is that none of the entities engaging in shadow banking is regulated (since they do not take deposits from the public) and none have direct access to central bank funding or safety nets like deposit insurance. Such definitions as there are emphasise the inter-relation with the traditional banking system via credit intermediation claims which facilitate the spread of systemic risk. The EU Green Paper identifies particular systemic problems presented by the prevalence, within shadow banking activities, of short term funding prone to risks of sudden and massive withdrawal; the build up of unsupervised leverage; and the circumvention of regulation/supervision by an intermediation process using legally separate structures. In short, the EU identifies shadow banking as a significant contributor to the 2007/8 crisis.

The Green Paper and the Deloitte Index also, however, point to the enormous benefits of a broadening of the available investment options and a significant reduction, in any event, in shadow banking activity. The EU, G20, FSB and the FSA all appear convinced, however, that, as banks' capacity to finance growth is increasingly constrained by tougher capital requirements, shadow banking will grow to fill the gap and that it needs to be subject to product driven supervision.

There is an obvious tension here, between the need to finance growth, currently constrained by banking regulation – and the regulators' determination to also regulate the exploitation of alternative funding sources.

terms of its counter-indemnity given BERR authority to demand the amount of its debt from "any other person". It was argued for Mr Ibrahim that the payment by UBS could only discharge LDV's debt if UBS acted as agent of LDV. UBS as a "stranger" to the transaction was clearly not acting as agent for LDV. The CA held that agency was not the critical factor. The question was whether UBS were acting under legal compulsion (regardless of whether this derived from a contractual obligation voluntarily assumed). Mr Ibrahim's counsel further argued that the obligation of UBS under the UPC600 LC terms was nevertheless an autonomous obligation to pay a sum of money against delivery of documents, quite separate from the underlying contractual matrix such that even if UBS acted under legal compulsion, it did not make the payment under its LC "on account" of LDV's debt. The CA accepted the autonomy principle, but thought it wholly permissible to look at the terms of the LC to determine what UBS was paying. The wording of the LC referred to the payment being made against a certificate that it "covered" (i.e. discharged) the unpaid sums due to BERR by LDV. The CA dismissed Mr. Ibrahim's appeal, holding that payment by UBS discharged LDV's liability under the counter-indemnity (and any liability that LDV might have had to BERR under principles of subrogation) and consequently no sums were due to BERR (or Mr Ibrahim as its assignee) under the Realisation Agreement.

In the courts

Contingent claims in solvent liquidations

Re Danka Business Systems Plc; Ricoh Europe Holdings BV v Spratt [2012] EWHC 579 (Ch)

Ricoh had acquired a number of companies from Danka on the terms of a share purchase agreement which included a tax indemnity. Danka went into members' voluntary liquidation and Ricoh lodged a proof pursuant to the tax indemnity setting out crystallised claims and contingent claims and requesting that the contingent claims be subject to a reserve to be retained by the liquidators prior to any distribution. The liquidators refused to hold a reserve and instead valued the contingent claims on a "most likely outcome" basis. Ricoh argued that the claims were contingent on the outcome of court proceedings in Italy and were incapable of being valued; that the contingency would be relatively short term given the stage of the Italian court proceedings; and that as a matter of principle, in any conflict between members and creditors in a winding up, the interests of creditors should come first. The court held that the liquidators had no choice but to act as they had pursuant to rule 4.86 of the Insolvency Rules 1986. Where a company in liquidation is subject to a contingent liability with an uncertain value, the liquidators had to place an estimated value on the debt and the creditor is entitled to prove for that amount only. In addition, whilst the liquidators could have postponed the service of notice setting a deadline for admission of proofs, their decision was not sufficiently perverse or unreasonable to warrant court interference. Ricoh has applied to the Court of Appeal for permission to appeal. Insolvent liquidations often involve an estimation of liabilities by liquidators. This, however, was a solvent liquidation with a significant surplus for members and if the case does go to appeal it should hopefully facilitate an authoritative review of the different approaches which might be taken on a creditors' and members' voluntary winding up.

FATCA Update

The main responses to the IRS FATCA regulations proposed in February 2012 relate to the limited time available to Foreign Financial Institutions (FFIs) to implement FATCA-compliant procedures and a real resistance to the foreign pass-through payment regime (which is not expected to be effective until 2017 at the earliest). The IRS has stated that it intends to issue, over the next few months:

- Individual draft FFI Agreements and the procedures required to be followed by FFIs to participate in FATCA;
- A model 'Government to Government' Agreement, under which the US and other countries (currently France, Germany, Italy, Spain and the UK, although it is reported that other countries are negotiating similar accords) would agree on an alternative approach to FATCA permitting reporting to their own home countries (for onward transmission to the US); and
- the release of information on another kind of inter-governmental agreement which would involve direct reporting by an FFI under the umbrella of an inter-governmental agreement.

Final regulations are expected to be issued by the end of the summer.

Recent transactions

We have recently advised **Macquarie Bank Limited, London Branch** on a £15m multicurrency revolving credit facility made available by it to Trade Finance Partners Limited.

Department News

We are pleased to announce that Charles Bischoff and Andrew Eaton will become partners in the firm's Banking and Corporate Recovery Department on 1 July 2012.

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