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CASE REVIEW SECTION

Innovate Logistics Ltd (In Administration) v Sunberry Properties Ltd **[2008] EWCA Civ 1261 (Mummery, Wall and Stanley Burnton LJ)**

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Innovate Logistics Limited ('the Company') was the lessee of a substantial cold store premises in Derbyshire ('the Property') under a lease dated 18 December 1998. The term was 30 years from that date at a basic annual rent of GBP 1,225,230 and the landlord was Sunberry Properties Limited ('the Landlord'). The Property was used by the Company to store customers' goods, pending distribution, in frozen, chilled or other conditions.

On 25 June 2008, an administration application was presented to the Court and on 30 June administrators were appointed ('the Administrators') and the business and assets of the Company (but not the Company's book debts) sold to Yearsley Holmewood Limited ('YHL') on a pre-packaged basis.

At the date of the administration order, GBP 20m worth of frozen foods was stored on 25,000 pallets at the Property. The Administrators feared that if the stored goods were not distributed in accordance with customer contracts, the value of the Company's substantial book debts would be depleted by cross claims. Accordingly, the sale to YHL was on terms that YHL fulfilled the outstanding customer contracts. For that purpose, the Company granted an occupational licence of the Property to YHL for 6 months.

The granting of the licence was in clear breach of the covenant against alienation contained in the lease. When YHL refused to take an assignment of the Lease, the Landlord sought permission under paragraph 43(6) of Schedule B1 to the Insolvency Act 1986 to commence proceedings for an injunction to terminate the licence and thus put right the Company's breach of covenant.

The application came before HHJ Simon Brown QC on 15 July 2008 on an urgent basis. Granting permission under paragraph 43(6), the learned Judge held that the purpose of the administration had been achieved 'on the very day of the administration order' by reason of the pre-pack going concern sale to YHL. As the granting of permission would not impede the achievement of the purpose of the administration it was unnecessary to carry out the exercise of balancing the interests of the Landlord against the interests of the Company's creditors in accordance with the Court of Appeal guidance in *Re Atlantic Computer Systems Plc* [1992] Ch 505 (CA).

The Administrators appealed. Their appeal was heard urgently on 1 August 2008 and at the end of oral argument, the Court announced its unanimous decision to allow the appeal. The reasons for the decision were handed down on 18 November 2008.

The Court of Appeal held that one of the main purposes of the administration was a continuation of the collection of the Company's book debts which could only be achieved if YHL continued to occupy the Property. Accordingly, the learned Judge was wrong to conclude that the purpose of the administration would not be impeded by the granting of permission because the mandatory injunction would, if granted, terminate the ability of YHL to carry out the contracts and to assist in getting in the book debts owed by customers. The learned Judge ought, therefore, to have carried out the balancing exercise in accordance with the *Atlantic Computer* guidance. When that exercise was carried out, i.e. when the loss relied upon by the Landlord was weighed against the potential loss to the creditors of the Company, the result was obviously in favour of refusing permission.

The primary loss identified by the Landlord if it were refused permission was the loss of its so-called 'bargaining position'. The bargaining position consisted of the threat of the mandatory injunction requiring the Company to terminate YHL's licence with the object of obtaining an agreement under which YHL would take an assignment or a new lease of the Property on terms that would be more beneficial to the Landlord than could be obtained on the open market. Stanley Burnton LJ doubted whether the loss of such a bargaining position was in fact a relevant consideration for the Court to take into account on an application under paragraph 43 of Schedule B1 and concluded (at [68]) that:

'I certainly do not think that the court should view an application by a lessor in such circumstances sympathetically. In a case such as this, where [the Landlord] contends that it is indisputably entitled to an injunction if it is permitted to bring proceedings, the court's principal, if not only, focus must be on the consequences of the grant of that injunction rather than on what [the Landlord] might obtain by the threat of those proceedings.'

Re Sigma Finance Corporation [2008] EWCA Civ 1303

Adam Al-Attar,¹ Barrister, 3-4 South Square, London, UK

In *Re Sigma Finance Corporation* [2008] EWCA Civ 1303, the Court of Appeal was required to determine whether Mr Justice Sales had correctly construed clause 7.6 of the security trust deed (the 'Security Trust Deed') pursuant to which the assets of Sigma Finance Corporation ('Sigma') were secured for the benefit of the holders of loan notes issued by the company and held by the security trustee appointed (the 'Security Trustee'). The Security Trust Deed was governed by English law and contained a jurisdiction clause which had enabled proceedings to be commenced in England.

The issue, very broadly, was whether Sigma's secured liabilities were to be discharged as they fell due or on some other basis, in the period following enforcement by the Security Trustee but prior to distribution of the company's assets. Lord Justices Lloyd and Rimer affirmed the decision of Sales J and held that Sigma's secured liabilities were to be discharged as they fell due in that period. Lord Neuberger, sitting as a judge of the Court of Appeal, also rejected a construction requiring the discharge of such liabilities *pari passu* but, dissenting, considered that clause 7.6 accelerated those liabilities in part and required the receiver appointed to pay an amount he considered 'safe', having regard to the likely amount available for final distribution at the end of the realisation process.

This case note considers the causes of the disagreement between the appellate judges and two aspects of the case which may have wider implications for the construction of such security documents.

The facts

Sigma had carried on business as a structured investment vehicle which used short to medium term funding to acquire longer term and hopefully profitable asset-backed and other financial securities. Sigma's principal source of short to medium term funding was intermediated securities in the form of loan notes issued by the company and secured against the longer term

assets acquired. The loan notes issued were held by the Security Trustee for the benefit of individual investors in accordance with the Security Trust Deed.

This investment structure relied on Sigma's continuing ability to repay, or rather to rollover, short to medium term funding. The structure failed when the market in asset-backed securities evaporated with the widening of the sub-prime mortgage crisis. Sigma was unable to repay existing liabilities through the issue of new loan notes, the sale of assets or other funding arrangements such as sale and repurchase transactions.

In these circumstances, the notice issued to the Security Trustee by a creditor providing a facility to Sigma constituted an enforcement event with an enforcement date effective from 2 October 2008. An immediate effect of enforcement was to trigger an asset realisation process which was to be completed within the prescribed 60 day realisation period ending on 29 November 2008 (the 'Realisation Period').

Clause 7.6 of the Security Trust Deed provided:

'[1] The Security Trustee shall use its reasonable endeavours ... to establish by the end of the Realisation Period a Short Term Pool, a number of Long Term Pools ... and a Residual Equity Pool.

[2] In order to establish such Pools, the Security Trustee shall during the Realisation Period (but not thereafter) realise, dispose of or otherwise deal with the Assets in such manner as, in its absolute discretion, it deems appropriate.

[3] During the Realisation Period the Security Trustee shall so far as possible discharge on the due dates therefor any Short Term Liabilities falling due for payment during such period, using cash or other realisable or maturing Assets of the Issuer.'

The assets allocated to the various short and long term asset pools were to correspond to the various secured liabilities in terms of maturity, payment dates and currency of payment. The long term pools were, moreover, to comprise a pool in relation to each series of loan notes.

Notes

¹ Simon Mortimore QC, Richard Sheldon QC, Felicity Toubé and Daniel Bayfield were counsel for the representative creditors. Gabriel Moss QC and Barry Isaacs were counsel for the receivers.

The issue

The Security Trustee had appointed an administrative receiver (the 'Receiver'), and the issue was whether the third sentence of clause 7.6 above and, in particular, the words 'so far as possible' required the Receiver to discharge secured liabilities as they fell due in the Realisation Period, or to discharge such liabilities on some other basis, for example in accordance with the scheme of *pari passu* distribution ordinarily applicable in insolvency cases.

The issue was significant because payment of liabilities on a first-in-time basis would entirely exhaust the assets which would otherwise form the short term pool (and long term pools). The Receiver had, in particular, identified four classes of creditor affected:

- (a) the holders of medium term notes maturing in the early part of the Realisation Period;
- (b) the holders of medium term notes maturing in the later part of the Realisation Period;
- (c) the holders of medium term notes maturing after the Realisation Period; and
- (d) the holders of notes maturing more than 365 days after the effective enforcement date.

If the available assets were realised and used to discharge notes in class (a), no assets would be available for distribution to classes (b), (c) or (d), and so on. For this reason, a representative creditor was appointed in respect of each class, respectively Party A, B, C and D.

Party A submitted that the Security Trustee was to discharge secured liabilities as they fell due, day by day, until it had no more assets with which to do so (paragraph 35). Party B also contended a first-in-time rule was the correct priority rule but that it must be applied in respect of the class of secured liabilities falling due within the Realisation Period (paragraph 36). Parties C and D, by contrast, argued that discharge of the secured liabilities on a *pari passu* basis over the class of secured liabilities as a whole was the correct construction (paragraph 37).

In the course of argument, a further construction emerged in which the function of clause 7.6 was to accelerate part payment of the secured liabilities falling due within the Realisation Period and which would otherwise have to be paid under clause 7.11 at the end of that period (paragraph 122). On this view, the Security Trustee was to discharge such liabilities to the extent he judged it 'safe' to do so, having regard to the amount he anticipated would be available for distribution at the end of that period (paragraphs 115 and 119).

First-in-time priority

Parties C and D argued a first-in-time construction was contrary to business common sense because:

- (1) the holders of loan notes all had essentially the same rights and it was 'pure chance' that the obligation to some matured within the Realisation Period (paragraph 42);
- (2) further, having regard to the detailed mechanics of what constitutes an enforcement event, Sigma had some choice as to the effective enforcement date, and so the onset of the relevant period (paragraph 43);
- (3) the scheme of distribution, as a whole, did not recognise any distinction amongst short term liabilities, or between short term and long term liabilities (paragraph 45); and
- (4) if 'so far as possible' were to be construed to mean 'so far as the available assets allow', the words would have no content because they would add nothing to the words 'using cash or other realisable or maturing Assets of the Issuer' at the end of the third sentence (paragraph 55).

Lloyd and Rimer LJ rejected these arguments because criticism of a first-in-time construction could not without more support a *pari passu* construction (paragraphs 58 and 87). Further, 'so far as possible' was not without content on Party A's construction as it protected the Security Trustee against any claim for breach of his obligations as trustee arising from a delay in payment due to the circumstances post enforcement (paragraph 56). Within the scheme of the Security Trust Deed, the *pari passu* rule was limited to distribution from each pool amongst the relevant class of liabilities in respect of that pool and had effect after the Realisation Period (paragraph 89).

Neuberger L similarly regarded a *pari passu* construction as unsustainable as a matter of language. A rateable distribution would be required whenever liabilities exceeded assets and, as such, 'so far as possible' would have to be construed to mean 'if possible' notwithstanding that the words naturally mean 'to the extent that' (paragraph 118).

Party B argued for a wider first-in-time rule on the basis that the words 'during such period' were without content on the narrow construction favoured by Party A, which required the Security Trustee to discharge maturing liabilities on a day-to-day basis (paragraph 47 and 73).

Lloyd and Rimer LJ rejected Party B's argument because 'on the due dates therefor' indicated that liabilities maturing within the Realisation Period were to be paid on maturity, and 'so far as possible' could not, for the above reasons, be construed as requiring a *pari passu* discharge of short term liabilities within the Realisation Period (paragraphs 74 and 91).

Accelerated payment

Neuberger L favoured the fourth construction which emerged in the course of argument, which required

the Security Trustee to discharge short term secured liabilities falling due within the Realisation Period to the extent it was 'safe' to do so having regard to the anticipated amount available for distribution at the end of that period.

He considered the submissions of Parties A and B to be 'unattractive in terms of business commonsense' principally because the Security Trustee would be required to carry out a 'fire-sale' in a weak market (paragraph 102). By contrast, he perceived no such problem in relation to the fourth solution, in which the Security Trustee was only 'to pay as much as he can be confident that the creditor concerned will receive if he had to wait for payment ... from the Short Term Pool at the end of the Realisation Period' (paragraph 111).

He also considered the fourth solution appropriate as a matter of language because to construe 'possible' as 'safe' was in line with the natural meaning of 'so far as possible' discussed above (paragraph 119), and the use of 'discharge' as opposed to 'pay' in clause 7.6 connoted part payment because other uses of 'pay' and 'payment' had been defined as 'redeem in full' (paragraph 120).

Lloyd LJ, with the agreement of Rimer LJ, rejected this construction because he considered 'discharge' to ordinarily mean 'paid in full' and found no indication that pro tanto discharge was the sense intended and, crucially, the Security Trustee Deed did not include any definition of the Security Trustee's obligation in relation to making an accelerated payment, or any protection in relation to the calculation of such a payment (paragraphs 64 and 65).

The construction favoured by Neuberger L is attractive because the obligations to discharge liabilities falling due within the Realisation Period and to make a distribution from the various pools formed at the end of that period each have a function notwithstanding the dramatic fall in the value of the secured assets. The fourth construction is nonetheless difficult to accept because the Security Trustee would have to participate in a distressed sale to some extent. In these circumstances, it is unlikely the parties intended a complex obligation to discharge certain liabilities in part. The obligation to pay secured liabilities as they fall due provides the Security Trustee with a complete defence to any potential claim because a 'fire-sale' is something the Security Trustee has to do to discharge his duty under the Security Trust Deed.

Analysis

The decision in *Re Sigma Finance Corporation* has no wider application. The issue was one of construction and, as highlighted above, can be explained as a straightforward application of the ordinary and well established principles of construction referred to in the

judgments. The way in which those principles were in fact applied may however have some wider impact.

First, Lloyd and Rimer LJ each had regard to the fact that the security documentation was extensive and was (probably) drafted by a team of commercial lawyers and, on this assumption, were inclined to reject any construction not apparent from the express language used (paragraphs 67, 86 and 87). This approach is difficult to accept. The identity of the draftsman leaves outstanding the question of construction and, as such, cannot properly be considered part of the 'relevant' contractual background (*BCCI v Ali* [2002] 1 AC 251, 296). The approach set out by Neuberger L at paragraphs 98 to 101 is the better approach. The majorities' reasoning is consistent with it, and their observations regarding the use of professional advisors merely reflect their conclusion that Parties B, C and D tried 'to load too much on too little' (paragraph 88).

Second, Lloyd LJ was inclined to treat the Security Trust Deed as a document akin to a constitutional document such as the memorandum and articles of association of a company because it 'affects the rights among themselves of a large number of people who are not parties to it' and he indicated that the implication of terms may not be possible for this reason (paragraph 38).

The soundness of this observation is open to doubt. First, the special approach to the construction of corporate constitutional documents flows from their public registration and the possibility that a third party may rely on them in their dealings with the company (*Scott v Frank F Scott (London) Ltd* [1940] Ch 794; *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCLC 693).

Second, the majority did in fact imply a term in order to accommodate liabilities which had matured prior to the effective enforcement date. Lloyd LJ considered that 'one would naturally expect' such liabilities 'to be paid with at least as high a priority as any other liability' and construed clause 7.6 'to read the sentence as if it said "any Short-Term Liabilities already due or falling due for payment during such period"' (paragraphs 49 and 52). Rimer LJ similarly regard the failure to make express provision for such liabilities a 'mistake' and held that 'the only rational interpretation ... is that the pre-enforcement debts are to be treated as impliedly included within the class of liabilities referred to' (paragraphs 82 and 90).

Assessed in this light, it is readily apparent the implication of terms may be necessary however complex the underlying documents, and the possibility of such should only be excluded at the outset for very good reasons. That Parties B, C and D did not advance arguments for the implication of any term in their favour merely reflects the likelihood that any term in line with their submissions would not have been accepted as obvious or reasonably necessary for the working of the Security Trust Deed.

Re Global Trader Europe Limited (in liquidation) [2009] EWHC 602 (Ch)

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Introduction

If a financial services firm fails, how should money in its various bank accounts be treated in its administration or liquidation?

The answer is reasonably clear at common law. If no trust of that money was effectively constituted, or no trust money can be traced, the money held in the various bank accounts is to be distributed in accordance with the statutory scheme of priorities ordinarily applicable.

The answer was less clear in cases subject to the client money rules created by the Financial Services Authority ('FSA') in exercise of their legislative power under the Financial Services and Markets Act 2000 ('FSMA'). These rules, enacted in various guises since their creation under the Financial Services Act 1986, impose a statutory 'trust' on money that is 'client money' and specify how such money is to be distributed upon failure of a firm. A number of questions flow from this basic scheme. When is money client money? What more, if anything, is required for the statutory trust to bite? In what circumstances, if any, might the protection so conferred be lost? How is client money subject to the statutory trust but outside the client money distribution rules to be distributed?

Sir Andrew Park has now provided answers to these questions, and others, in *Re Global Trader Europe Limited (in liquidation)* [2009] EWHC 602 (Ch). The case is the first to construe the client money rules in force prior to the implementation of the Markets in Financial Instruments Directive ('MiFID') on 1 November 2007 ('CASS 4') and the first to consider the successor rules enacted in the light of that directive ('CASS 7').

This article summarises the judge's conclusions and dicta and considers their likely application in future cases.

Facts

Global Trader Europe Limited (in liquidation) ('GTE') was a derivatives broker and carried on business for clients wishing to enter into spread bet transactions ('SBT') and contracts for difference ('CFD'). These transactions enabled clients to speculate on the movement of a particular commodity or index for so long as the transaction remained 'open'.

GTE did not mediate between its clients and third parties as a traditional broker but contracted with its clients as principal and entered into corresponding hedges with third parties (paragraphs 17 and 21). For this reason, the firm required each client –

- (1) to open an 'account' on its standard terms and conditions prior to the placement of any trade in order that a running ledger account could be kept of the balance owed to or by GTE by or to its client; and
- (2) to make a payment of margin to cover potential losses and honour further margin calls in the event that the initial margin proved insufficient (paragraph 20).

In this way, GTE aimed to profit from fees and commissions and maintain a market neutral position by hedging each client trade or 'bundle' of client trades. The firm was therefore only exposed to market risk indirectly. A client might fail to provide margin or to satisfy a call for margin with the consequence that GTE would have to shoulder loss arising from a hedged transaction from its own reserves.

GTE did suffer such a loss and, in the event, its own reserves proved to be insufficient (paragraph 21). The FSA intervened in its business and placed a restriction on new trading activity. The firm was subsequently placed into administration on 15 February 2008 and entered creditors' voluntary liquidation on 17 June 2008, as no buyer for the business was found.

Notes

¹ The author was second counsel for the Rossib class. Felicity Toube was first counsel for the Rossib class. Glen Davies was counsel for the Crawford-Brunt class.

Issues

The joint administrators identified a number of issues which eventually fell to be determined in the liquidation:

- (1) What money held by GTE was client money within CASS 4 or CASS 7?
 - (a) Was only money segregated in a client money bank account client money?
 - (b) If so, was money in a non-segregated account as a result of –
 - (i) an incomplete transfer instruction pre-administration, or
 - (ii) a subsequent receipt of funds from third parties in relation to client trades or bundles of trades, nevertheless client money?
- (2) Who was entitled to the client money held by GTE?
 - (a) Were only clients treated as segregated clients by GTE entitled to such money?
 - (b) Were clients who had signed a contract purporting to 'opt-out' from the client money rules but which did not in fact comply with CASS 4.1.9R also entitled to such money?
 - (c) Were clients who had received a 'one-way' notice in an email purporting to transfer to GTE funds held for them pursuant to CASS 7.2.3R entitled to share in that money?
 - (d) Were clients who had 'closed' their positions prior to the failure of the firm entitled to share in that money notwithstanding a transfer of funds to GTE in accordance with CASS 7.2.3R?

The facts giving rise to these issues were complicated because GTE's trading life spanned two distinct regimes, CASS 4 and 7, but the contest was a relatively straightforward one between trust creditors, unsecured creditors and clients who claimed to be trust creditors.

The precise shape of this contest is readily apparent from representative respondents appointed:

- (1) Mr Andre Crawford-Brunt represented the clients treated as segregated clients by GTE and for whom money had been segregated in accounts separate from the firm's general accounts ('Crawford-Brunt').
- (2) Rossib (Cyprus) Limited represented clients not treated as segregated clients by GTE, which it had purported to opt-out under CASS 4.1.9R and, subsequently, to enter into a title transfer arrangement in accordance with CASS 7.2.3R ('Rossib').
- (3) Sergey Soukholinski represented a sub-set of the class represented by Rossib who had closed out their positions prior to the failure of the firm ('Soukholinski').

- (4) City Facilities Management Limited represented the firm's unsecured creditors ('City Facilities').

The precise boundaries of each class are unimportant for the purpose of this article, but it is necessary to set out six background matters to draw out the issues from the point of view of the various respondents.

(1) Segregation

GTE had operated several general company accounts in various currencies (the 'non-segregated accounts') and several segregated client bank accounts in the same currencies as the non-segregated accounts (the 'segregated accounts').

Into these accounts, GTE had received payments of margin from clients and payments from counterparties in respect of successful client trades or bundles of trades.

The evidence was –

- (1) that GTE had performed a daily reconciliation of the segregated accounts and the ledger accounts, transferring to or from the segregated accounts from or to the non-segregated accounts the amount necessary to balance the segregated accounts with the ledger accounts for segregated clients; and
- (2) that, at some point prior to the firm's failure, each of the non-segregated accounts had become heavily overdrawn.

As at 15 October 2008, the liquidators held GBP 2,047,722 in the segregated accounts and GBP 20,205,767 in the non-segregated accounts, of which GBP 18,646,490 represented recoveries from counterparties in respect of client trades or bundles of trades.

Rossib and Soukholinski claimed that all clients were entitled to share in client money in whatever account (the 'main claim', paragraph 7) and, in the alternative, to be entitled to share in the balance on the segregated accounts ('the £2m plus issue', paragraphs 4 and 8).

Crawford-Brunt disputed the GBP 2m plus issue, and City Facilities contended that the balance of the non-segregated accounts was available for distribution to creditors generally. Segregation was said to be essential for constitution of the statutory trust and, further, the accounts had been heavily overdrawn and replenished with firm money and not client money.

(2) Client classification and title transfer collateral arrangements

Pre 1 November 2007, GTE classified clients as either 'private' or 'intermediate' customers. Post 1 November 2007, GTE 'grandfathered' these existing clients into,

respectively, the new 'retail' and 'professional' client categories introduced by MiFID.

Pre 1 November 2007, GTE treated only money received from, or held for, private customers/retail clients as client money subject to the client money rules (paragraphs 23 to 25). This treatment flowed from the connection between the client money rules and client classification rules.

A firm was required to classify a client as either a private or intermediate customer by reference to certain qualitative criteria (paragraph 26). On the basis of that classification, a firm might then offer intermediate customers the opportunity to opt-out from the client money rules under CASS 4.1.9R.

GTE had contracted on such a basis, requiring clients to supply information relevant to classification when submitting an account application form and only accepting a client's offer in respect of CFD transactions if satisfied that the client was in fact an intermediate customer who would be opted-out from the client money rules then in force (paragraphs 27 to 29). GTE did not contract in the same way in relation to SBT clients but reserved the right to reclassify a client as an intermediate customer in the light of the information supplied.

Post 1 November 2007, and following the grandfathering of existing clients into the new categories, GTE purported to transfer title to funds received from, or held for, such clients by a one-way email circulated to existing CFD clients on or about 31 October 2007 in the following terms (paragraph 41 to 42):

'Since the funds you place in your trading account are for use in the course of Global Trader's investment business for the purpose of securing or otherwise covering present or future, actual or contingent or prospective obligations, you are informed that these funds will not be regarded as 'Client Money' per the FSA Client Money Rules and will not be subject to the protections conferred by these regulations.'

This additional step was taken because the opt-out under CASS 4.1.9R was not continued under CASS 7 because, in relation to investment businesses within the material scope of MiFID, it was considered incompatible with the likely construction of the directive indicated by recital 27. The FSA considered that only a title transfer collateral arrangement (a 'TTCA'), or analogous arrangement, was compatible with MiFID and, as such, did not re-enact CASS 4.1.9R but enacted CASS 7.2.3R. The connection between classification and client money was retained only insofar as the client's best interest rule indicated that more was required of a firm effecting a TTCA in relation to a retail client, CASS 7.2.7G.

Crawford-Brunt and City Facilities argued that Rossib (and so Soukholinski) was not –

- (1) a client 'for whom that *money* is held' within CASS 7.7.2R(2), or

- (2) a client with a '*client money* entitlement' within CASS 7.9.6R,

because there had been a valid opt-out under CASS 4.1.9R and, further and in any event, a valid transfer of title under CASS 7.2.3R.

The case could not be resolved on this basis alone because, assuming there was no valid opt-out under CASS 4.1.9R, not all clients who should have received the email circulated on 31 October 2007 did.

(3) *Closure of open positions pre-administration*

GTE had a number of clients who had closed their positions pre administration with the consequence that any money held for them could not strictly be held as collateral against a future liability.

Soukholinski represented this sub-set of the clients within the Rossib class. He contended that upon closure of a client's position any transfer of title under CASS 7.2.3R lapsed, with the consequence that any money so transferred was once again client money, because a transfer of title pursuant to that rule was subject to a continuing condition that the transfer should secure some future obligation.

(4) *Incomplete transfer*

Prior to the administrators' appointment, Barclays Bank plc, GTE's bank, had failed to comply with an instruction from the firm to transfer GBP 503,157.55 from the non-segregated accounts to the segregated accounts. Barclays was aware that GTE was to enter administration the next day.

Crawford-Brunt contended that this sum should be transferred to the segregated accounts for distribution to the segregated clients ('the incomplete transfer issue', paragraph 5).

(5) *Further shortfalls*

The FSA's restriction on new trading activity precluded the administrators from entering into new transactions because GTE would have been fully exposed to a risk of loss. The administrators accordingly closed clients' trades in which the parallel hedge had determined (because no new hedge could be put in place) and kept open only clients' trades in which a parallel hedge continued and, as a consequence, payments were subsequently received by GTE which were, in a loose sense, attributable to segregated clients' trades or bundles of trades.

At an interim hearing on 3 October 2008, Mr Justice David Richards was asked to determine the date at which clients' open positions under SBT and CFD

contracts were to be valued for the purpose of calculating their '*client money* entitlement' under CASS 7.9.6R for the purpose of the client money distribution rules.

David Richards J declared (paragraph 113):

'For the purposes of distribution pursuant to CASS 7.9.6R, the client money entitlement calculated in accordance with CASS 7.9.7R of each ... client is to be calculated as at the date of the Appointment. The liquidators shall, in respect of each position held by each such client which was closed during the administration or liquidation of the Company, quantify the client money entitlement as though that position was liquidated and closed at the closing or settlement prices published by the relevant exchange or other appropriate pricing source at the time of the Appointment.'

This notional closing out of open positions as at 15 February 2008 caused a notional profit or loss to be realised for the clients concerned, which raised the question as to whether some amount of the firm's own money should be transferred from the non-segregated accounts to the segregated accounts equivalent to the further shortfall across those accounts equal to the net notional profit ('the further shortfalls issue', paragraphs 11 and 113).

Crawford-Brunt argued that such an amount should be transferred and was opposed by City Facilities on this issue.

(6) *Post-administration closings*

The notional closure of clients' open positions as at 15 February 2007 also raised a further question in relation to the contractual profit realised when those positions were actually closed during the course of the administration ('the post-administration closings issue', paragraphs 5(2) and 121). For example, if a segregated client's position was valued at GBP 100 as at 15 February and was subsequently closed at a value of GBP 150 at a later date, was that client entitled to a further GBP 50?

Crawford-Brunt contended that such an amount should be transferred as the administrators had a statutory duty to open new segregated accounts and to transfer such sums into them as they accrued. That they had not done so was not a reason for the Court not to do so now.

Accordingly, the contest between the representative respondents was as follows:

- (1) Crawford-Brunt sought to improve his position at the expense of City Facilities (the incomplete transfer and further shortfall issues), and
- (2) Rossib and Soukholinski sought to improve their position at the expense of City Facilities (the main claim) or, in the alternative, Crawford-Brunt (the GBP 2m plus issue).

Held

Sir Andrew Park rejected the main claim of Rossib and Soukholinski and resolved the GBP 2m plus issue and the further shortfall issue in favour of Crawford-Brunt. City Facilities was successful in opposing the incomplete transfer and post-administration closings issues and, as such, secured for the general creditors the balance of the non-segregated accounts less the further shortfall amount transferred into the segregated accounts.

The judgment is lengthy and it is useful to try to state the resolutions to the various issues without reference to the detailed facts:

- (1) The statutory 'trust' under CASS 4.2.3R and 7.7.2R attaches to money that is 'client money' within, respectively, CASS 4.1.1R and 7.2.1R (paragraphs 36(iv) and 39(xi), 80).
- (2) The transition from CASS 4 to CASS 7 did not affect the rights of creditors or clients in relation to client money. If a firm held client money for a client under CASS 4, it would continue to do so under CASS 7 as such money is client money within CASS 7.2.1R; conversely, if a client was in fact only a creditor of the firm under CASS 4, he would continue as a mere creditor from 1 November 2007 in the absence of some conduct by the firm to create a trust thereafter (paragraphs 38 and 87).
- (3) Segregation is not required for constitution of the statutory trust in respect of money 'received from' a client within CASS 4.1.1R or 7.2.1R. Client money, for example money paid as margin, mistakenly paid into a non-segregated account remains client money and the fund created is immediately to be treated as mixed fund (paragraphs 36(iv), 55, 56, 59, 60 and 80).
- (4) Segregation is necessary for constitution of the statutory trust in money received as firm money in respect of client trades or bundles of trades. Unless and until such money is segregated there is no client money 'held for' clients within CASS 4.1.1R or 7.2.1R even though, from the point of view of the client, such money represents his profit on his trade (paragraphs 36(i) and (v), 39(ii) and (viii), 61-74 and 127).
- (5) The identification of client money is essential for the integrity of the statutory trust and is ordinarily ensured by segregation, but, in simple cases, it may be possible to identify client money held in a non-segregated account, for example the simple case of mistaken payment above. In the absence of some identifiable client money, the statutory trust cannot attach to anything and must fail for uncertainty of subject-matter (paragraphs 57, 59, 65 and 81).

- (6) CASS 3 is a regime distinct from CASS 4 and CASS 7, and a right to use arrangement under CASS 3 was not so wide as to effect a transfer of money that was otherwise client money within CASS 4.1.1R or 7.2.1R to the firm upon receipt into a non-segregated account (paragraph 58).
- (7) CASS 4.1.9R requires a written acknowledgement of the three matters set out in that rule, namely –
- (a) the money will not be subject to the protections conferred by the client money rules;
 - (b) as a consequence, this money will not be segregated from the money of the firm in accordance with the client money rules and will be used by the firm in the course of its own business; and
 - (c) the market counterparty or intermediate customer will rank only as a general creditors of the firm.
- These are conditions for an effective opt-out from the client money rules under CASS 4 and a failure to comply renders a purported opt-out ineffective (paragraphs 30, 36(ii) and 56).
- (8) CASS 7.2.3R does not prescribe any particular form for a TTCA, but an arrangement must closely follow the words set out in that rule, namely –
- (a) a client transfers full ownership of money to a firm
 - (b) for the purpose of securing or otherwise covering present or future, actual or contingent or prospective obligations.
- The effectiveness of a TTCA turns solely on these matters and not upon the classification of the client (paragraphs 39(iii) and 79).
- (9) CASS 7.2.3R effects a transfer of title to client money from the client to the firm once and for all and it is not a continuing condition of that transfer's validity that there be some future obligation the performance of which is secured against that money. If title is transferred, there is no client money (paragraphs 74-76, 84 and 88-89).
- (10) CASS 4 and 7 are regimes subordinate to the insolvency regime ordinarily applicable. The client money rules apply to determine pre-insolvency entitlements which are to be respected in a firm's administration or liquidation but those rules do not override the insolvency regime so as to provide continuing protection for clients. Clients have no proprietary claim to post-administration profits arising from positions closed during the course of the administration and have only a claim in debt for which they can prove in the subsequent liquidation (paragraphs 121-135).
- (11) The entitlements of segregated clients are nonetheless to be protected to the extent that

an amount equal to the shortfall in the firm's segregated accounts (relative to the value of the segregated clients' entitlements as at the date of the firm's failure) is to be transferred from the non-segregated accounts to the segregated accounts to make good that shortfall (paragraphs 113-119).

In so holding, the judge rightly recognised that the main claim of Rossib and Soukholinski was not really a proprietary claim but a priority claim. Rossib and Soukholinski did not point to any transactional link, or series of such links, which identified any part of the funds held by GTE as client money subject to the statutory trust. They instead claimed priority as clients wrongly treated as non-segregated clients by GTE. For this reason, the judge recognised an analogy with a floating charge which would crystallise upon the failure of the firm in order to secure the debt owed to clients (paragraphs 90-91).

A priority protection of this sort could have been adopted in the financial services sector, but the judge rejected this construction of the statutory scheme enacted, having regard, in particular, to the trust mechanism expressly adopted. He recognised that a statutory trust might have different properties to a private law trust but that the use of a trust concept did import into the statutory scheme some of the limitations inherent in the common law (paragraph 91).

The statutory position is, on this basis, not much different from the common law position except that (and crucially) clients are, firstly, not dependent upon contractual bargaining to secure the benefit of a trust arrangement and, secondly, there is some slight protection against the failure of a firm to carry out its obligations. Subject to the point discussed in the next section, a bare failure to segregate does not appear to render the statutory trust invalid to the extent that client money can be identified as held in a non-segregated account.

The identification of client money in a non-segregated account seems to mean the same as tracing, which is consistent with the modern explanation of those rules as rules of evidence. The judgment is not precisely clear on this point because, while rejecting the main claim of Rossib and Soukholinski, the judge left open the possibility of tracing (paragraphs 60, 81 and 82). It is not however easy to see how the process of identifying the subject-matter of the statutory trust could be any different from the process of tracing, especially as the starting point in each case is a mixed fund into which, or from which, client money cannot straightforwardly be followed.

Dicta

The judge indicated that a failure to segregate client money may only in fact give rise to a claim for damages

for breach of statutory duty in accordance with FSMA ss 150 and 151 (paragraphs 92 and 93).

This construction is difficult to accept. The sections provide as follows:

'150 Actions for damages

- (1) A contravention by an authorised person of a rule is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

151 Limits on effect of contravening rules

- (1) A person is not guilty of an offence by reason of a contravention of a rule made by the Authority.
- (2) No such contravention makes any transaction void or unenforceable.'

The 'contravention' identified by the judge was 'not keeping [client money] distinct in a segregated account', but a failure to properly segregate client money cannot be a 'contravention' within –

- (1) s 151(2) (or s 151(2), which uses the same concept as its counterpart, referring to 'such contravention'), because a failure to segregate is exactly that and not a 'transaction' capable of being rendered 'void or unenforceable'.
- (2) s 150 because –
 - (a) it is incredible that the legislature intended the meaning of 'contravention' to shift across two correspondent provisions, and
 - (b) in all cases –
 - (i) a client already has an unsecured claim in debt nominally equivalent to the proprietary claim he seeks to make, and
 - (ii) as such, any concurrent tortious claim would add nothing (except perhaps in cases of consequential loss) and (except for such special cases) would run head long into the rule against double recovery.

In other words, a failure to segregate is not anything that can be avoided or rendered unenforceable because it is nothing, and to provide a concurrent claim in tort is pointless except perhaps in cases of consequential loss where it would rationally supplement a client's claim in debt.

The true purpose of s 151(2) is to protect 'transaction[s]' against the potential impact of 'a contravention of a rule made by the Authority' and s 150 provides a corresponding claim for breach of statutory duty for loss suffered.

Assessed in this light, the judge's suggested construction may not be followed in future cases, but the issue begs the question whether or not some other failure might be caught by these provisions.

The parties, for example, had been concerned with whether or not the failure to comply with CASS 4.1.9R and 7.2.3R was a 'contravention'. The judge did not consider this matter but it is, for reasons similar to those above, difficult to see how such a failure is a 'contravention' in the sense intended. A firm has no obligation to secure for itself the benefit of money that would otherwise be client money, and CASS 4.1.9R and 7.2.3R merely prescribe the means by which such a result is to be secured, if desired. As such, a failure to properly engage those rules is not a 'contravention' because there is no breach of any obligation. The logical extent of applying the judge's reasoning is that in trying but failing to secure an opt-out or title transfer there is somehow some breach of statutory duty. That it is very difficult to imagine any loss in such a circumstance is a fairly firm indicator that this construction is not correct.

A more plausible application of the judge's reasoning is to construe the sections as having different meanings. That is, a failure to comply with CASS 4.1.9R and 7.2.3R may benefit from the saving in s 151(2) but may not constitute a breach of a rule giving rise to a cause of action under s 150(1). This construction must also be doubted because, firstly, it requires a construction of two correspondent sections in radically different ways and, secondly, it would render CASS 4.1.9R and 7.2.3R nugatory contrary to the judge's conclusion that the prescribed conditions in CASS 4.1.9R must be complied and the form of words in CASS 7.2.3R closely followed.

Comment

The force of the judge's conclusion in relation to the main claim of Rossib and Soukholinski is apparent. A contrary construction of the statutory scheme would enable a simple priority rule to alter on insolvency the agreed rights of the firm and its clients. GTE was a derivatives broker which contracted with its clients as principal and entered into parallel contracts with third parties. If the main claim had succeeded, it would have enabled Rossib and Soukholinski to reach across that contractual divide to profits due to GTE and which ought to have been distributed to the firm's general creditors.

For the same reason, it is very difficult to accept the judge's reasoning in relation to the further shortfall issue and its apparent reconciliation with the incomplete transfer and post-administration closings issues.

The judge held at paragraph 116:

'[T]here should not be a further shortfall ... [T]he logical and correct corollary of the notional closing of open positions ... is that Global Trader ... should transfer out of its *own funds* ... to the segregated accounts an amount equal to the net increase in the credit balances of segregated clients arising by reason of the effect of provisions in CASS 7 as declared

in David Richards J's order. If there had been a net decrease I would have said that there should be an appropriate transfer in the other direction: from the segregated fund to the general funds held by the liquidators.' (Emphasis added.)

The judge reconciled this conclusion with the incomplete transfer issue in paragraph 117:

'[T]he shortfall was not brought about by the administration or, so far as I know, by the events which led to the administration.'

and paragraph 118:

'The 'further shortfalls', the origin of which I have described, are different. They were [1] *directly brought about by the administration* and [2] *the impact upon it of binding legal rules*, the effect of which was declared by David Richards J's order.' (Emphasis added).

The distinction here is one without a difference because the judge's resolution of the incomplete transfer issue flowed from a construction of the rules as much as David Richards J's reasoning in relation to valuation. The judge's reasoning on the incomplete transfer issue in fact flowed from a construction of the very same rule construed by David Richards J (paragraphs 108 to 110). It is, as such, difficult to see how one situation but not the other was brought about by the administration because the resolution of those issues (whatever the conclusion) must flow from those rules.

The judge also provided a positive reason in support of his conclusion later on in paragraph 118:

'Yet the purpose for which the law provided that the segregated fund should exist was to protect the segregated clients against a situation where a firm like Global Trader owes money to them but is not able to pay it.'

and in paragraph 119:

'The logic which led to notional closings of positions within the rolling cash system being associated with the appropriate cash transfers between Global

Trader's bank accounts and the segregated accounts also leads to the notional closings of all open positions on 15 February 2008 pursuant to David Richards J's order being associated with the appropriate cash transfer between Global Trader's bank account and the segregated account.'

The fact that, in a general sense, the purpose of the rules is to protect segregated clients is not an argument one way or the other because it leaves at large the questions how and to what extent such clients are to be protected. It is, in effect, a narrower reconstruction of the argument that clients are to be protected above other creditors, which was put forward by Rossib and Soukholinski and rejected.

The analogy with the rolling cash basis takes the argument no further because –

- (1) as the judge rightly recognises in paragraphs 54 to 70, the failure to perform an obligation, here the reconciliation of the segregated accounts with the segregated balances, does not mean the court should treat it as having been performed, and
- (2) the operation of the firm's accounts as a going concern has nothing to say about the position on insolvency governed by the statutory rules applicable.

This is an aspect of the case on which City Facilities should have succeeded and which a court may be very reluctant to follow in the future.

The puzzle is why this result was ever attractive. Given the contractual divide between clients, the firm and its counterparties, it seems reasonable that an administrator or liquidator should be able (a) to keep open profitable counterparty transactions for as long as possible to the benefit of creditors generally and (b) to value all claims as at the date of appointment, being the notional date for proof and distribution. The judge recognised this much in relation to the post-administration closings issue. Its logical extent is that a segregated client should only be able to prove for any further shortfall.

Cross Border Data Transfer: *In The Matter of Madoff International Securities Limited* [2009] EWHC 442 (Ch)

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The Madoff fraud and its denouement

On 11 December 2008, the world awoke to the astonishing news that Bernard L Madoff, a former chairman of the Nasdaq stock exchange in New York and highly respected Wall Street investment manager, had admitted that his investment company, Bernard L Madoff Investment Securities LLC ('BMIS'), was nothing more than a giant 'Ponzi' scheme. Losses to the upwards of 4500 investors in BMIS are estimated to be between USD 50 and 65 billion. On 12 March 2009, Mr Madoff pleaded guilty to various charges including securities fraud, investment adviser fraud, mail fraud and perjury.

Almost immediately after Mr Madoff confessed to his crimes in December 2008, the Securities and Exchange Commission ('SEC') in New York moved rapidly to bring BMIS and Mr Madoff's assets under its control by making applications to the United States District Court, Southern District, which resulted in the following orders:

- (a) On 12 December 2008, a temporary restraining order ('TRO') was made against Mr Madoff and BMIS and a Mr Lee Richards of Richards Kibbe & Orbe LLP was appointed receiver (the 'US Receiver') over the assets of various entities including Madoff Securities International Limited ('MSIL').
- (b) On 15 December 2008, pursuant to the Securities Investment Protection Act (codified in Title 15 of the United States Code sections 78aaa-111) a trustee ('the SIPA Trustee') of the assets of BMIS was appointed.
- (c) On 18 December 2008, the TRO and the appointment of the US Receiver were continued.

MSIL is an English private limited company incorporated on 11 March 1983 whose shares are wholly owned by Mr Madoff and members of his family. Although authorised by the FSA MSIL appeared to carry out proprietary trading activities for Mr Madoff's personal

account alone. As a result of the orders made on 12 December 2008 in New York, various banks who were notified of the orders and who held accounts for MSIL refused to carry out further instructions on behalf of MSIL. The result was that MSIL's business was frozen and the directors felt that they had no option but to petition for the appointment of provisional liquidators.

On 19 December 2008, Sir John Lindsey appointed Mark Byers, Andrew Hosking and Stephen Akers of Grant Thornton LLP joint provisional liquidators (the 'JPLs') of MSIL. The FSA expressly approved the appointment of the JPLs and the very extensive powers and functions that they were given by the order including the power to investigate the affairs of the MSIL. The order of appointment further provided that the JPLs would cooperate as appropriate with the US Receiver, the SIPA Trustee and the FSA and that the JPLs would use their best endeavours to provide the US Department of Justice and the SEC the same information as that provided to the US Receiver the SIPA Trustee and the FSA.

The cooperation provisions were included in recognition of the fact that the Madoff fraud was multi-jurisdictional involving investors and assets situated throughout the world and that the job of identifying and realising those assets would be best accomplished if the various regulatory authorities and court-appointed officers cooperated in the collation and exchange of information in order to avoid duplication and save costs.

The Data Protection Act 1998

The Data Protection Act 1998 (the 'DPA') was enacted in part to give effect to Council Directive 95/46/EC on the Protection of Individuals with regard to the Processing of Personal Data. The DPA is concerned to control the way in which personal data about an individual are gathered, processed and used. '[P]ersonal data' is defined by the DPA as data which relates to a living

Notes

¹ The authors were both retained by the joint provisional liquidators of Madoff Securities International Limited.

individual who can be identified (a) from those data or (b) from those data and other information which is in the possession of, or is likely to come into the possession of, the data controller and includes any expression of opinion about the individual and any indication of the intentions of the data controller or any other person in respect of the individual.² 'Data' is defined widely to cover almost all information that is recorded electronically or as part of a filing system. A 'data controller' is a person who determines the purposes for which and the manner in which any personal data are or are to be processed.³

Section 4 of the DPA refers to the data protection principles set out in Part 1 of Schedule 1 to the Act with which a data controller must comply. Failure to adhere to the data principles exposes a data controller to a claim for compensation from an individual who suffers damage or distress by reason of the failure.⁴ The data principles cover a wide field. They include the eighth principle which provides:

'personal data shall not be transferred to a country or territory outside the European Economic Area unless that country or territory ensures an adequate level of protection for the rights and freedoms of data subjects in relation to the processing of personal data.'

The DPA contains guidance on the interpretation of the data protection principles. The guidance as to the meaning of 'an adequate level of protection' in the eighth principle is, helpfully, 'a level which is adequate in all the circumstances of the case'!

It was immediately appreciated at the commencement of the provisional liquidation that the JPLs were data controllers and that therefore they would be subject to the provisions of the DPA. It was also apparent that transfer of data to the US, a country outside the EEA, and in particular to the SIPA Trustee was problematic. The US takes a sectoral approach to data protection resulting in a patchwork of federal and state laws and self-regulatory frameworks which do not provide the comprehensive protective coverage of Council Directive 95/46/EC and the DPA. As a result the US, as a country outside the EEA, is not regarded as having an adequate level of protection within the meaning of the Council Directive and the DPA.

In 2000, the European Commission adopted a Decision which determined that an arrangement put in

place by the US Department of Commerce known as 'safe harbor' did provide an adequate level of protection for personal data transferred from the EEA. The safe harbor scheme allows US companies to adhere voluntarily to a set of data protection principles which are recognised by the Commission as meeting the requirements of the Directive. However, it was doubtful whether the SIPA Trustee would be eligible to participate in the scheme because it is only open to commercial organisations.⁵

The application under Insolvency Act 1986, section 112

Since the order appointing the JPLs envisaged cooperation between the US-based SIPA Trustee and the JPLs and such cooperation would inevitably involve the transfer of data to the US which was likely to include personal data, it was important that such transfers did not infringe the DPA. In order to explore the extent to which the JPLs could make transfers of personal data to the SIPA Trustee the JPLs made an application for directions under section 112 of the Insolvency Act 1986 at the same time that the SIPA Trustee sought recognition of his appointment in the UK under the Cross-Border Insolvency Regulations 2006.⁶

The application sought a direction that subject to the JPLs being satisfied that the provision of the information was in the interests of the provisional liquidation of MSIL, they were at liberty to disclose to the SIPA Trustee certain categories of information including customer statements, wire transfers and/or records of funds transfers by or on behalf of MSIL, personnel files and communications with any recipients of funds transferred by or on behalf of MSIL. Such information was likely to include personal data but given the volume of data held by MSIL it was highly unlikely that the JPLs would be able to identify all data that was personal without expending substantial and disproportionate sums of money. Further, and in any event, even if personal data could be identified it was likely that it would be of interest to the SIPA Trustee and therefore the JPLs would wish to transfer the data to the US.

Schedule 4 of the DPA sets out certain exceptions to the application of the eighth principle. These include:

- Where the data subject has given his consent to the transfer.⁷

Notes

2 See *Durant v Financial Services Authority* [2004] FSR 28 [28]-[29] and *Criminal Proceedings against Lindqvist* [2004] QB 1014 at 1031 at [19]-[27] for a discussion of the meaning of 'personal data'.

3 Section 1(1) DPA.

4 Section 13 DPA.

5 See Rosemary Jay, *Data Protection Law and Practice* (2nd edn, Sweet & Maxwell, 2007), para. 8-25.

6 SI/2006/1030 which enacts legislation based on the provisions of the UNCITRAL Model Law on Cross-Border Insolvency.

7 Schedule 4, para. 1.

- The transfer is necessary for reasons of substantial public interest.⁸
- The transfer –
 - (a) Is necessary for the purpose of, or in connection with, any legal proceedings (including prospective legal proceedings),
 - (b) Is necessary for the purpose of obtaining legal advice, or
 - (c) Is otherwise necessary for the purposes of establishing, exercising or defending legal rights.

The judgment

Mr Justice Lewison was persuaded that obtaining the consent of the data subject to the transfer was impracticable. The amount of data involved meant that in many cases the JPLs would not know themselves, necessarily, whether any particular data related to a data subject. Also the nature of the JPLs' investigations were such that they might not in many cases want an individual to know that they were transferring data containing information concerning that individual.

That left the 'substantial public interest' exception and the 'legal proceedings' exception. Mr Justice Lewison was satisfied that it was in the public interest in order to unravel the fraud of the magnitude involved in the collapse of BMIS that transfers of data to the SIPA Trustee which might contain personal information relating to a data subject came within the substantial public interest exception on the facts of the case.

Mr Justice Lewison was also persuaded that this was a proper case for the 'legal proceedings' exemption to apply, at least in so far as (a) and (c) were engaged. He accepted that the unravelling of the fraud would undoubtedly involve legal proceedings and that there were in existence two such proceedings already on foot, namely the court-controlled liquidations of BMIS in New York and the provisional liquidation of MSIL in England. As for (b), Mr Justice Lewison made no

finding that transfers were necessary for the purpose of obtaining legal advice. However, it is evident from ICO guidance⁹ in this area that the exemption is intended to be interpreted widely. An example given in the guidance is where a parent company based in a third country is sued by an employee of the group based at one of its European subsidiaries. In such circumstances the transfer of data relating to the employee by the European subsidiary to the parent company for the purposes of the defence would not be regarded by the ICO as breaching the DPA. The interesting aspect of the exemption from the perspective of officeholders in the position of the JPLs is that the ICO guidance does not condemn the transfer of personal data where the purpose is to assist the recipient in the non-EEA country rather than to assist the English office-holder. It is quite possible that data in the possession of the JPLs will be required by the SIPA Trustee in order to consider claims that BMIS has in the US. The ICO guidance provides a high degree of comfort that a transfer for such purposes would be protected by the exemption.

As Mr Justice Lewison made clear during argument any directions given to the JPLs would not bind any individual whose personal data was illegally transferred. However, the fact that the JPLs had applied for directions in relation to their obligations under DPA might well provide them with a defence if they do unwittingly breach the requirements of the DPA and a claim is made against them for compensation. Under section 13(3) it is a defence to a claim for compensation for the data controller to show that he took such care as in all the circumstances was reasonably required to comply with the Act.

The effect of the judgment is that the JPLs in this case can be reasonably confident that transfers of personal data to the SIPA Trustee will not infringe of the DPA or if they do, section 13(3) will provide a defence. In addition the judgment is likely to have wider uses. In most cross-border cases it is likely to be possible to rely on the 'substantial public interest' or 'legal proceedings' exemptions to justify the transfer of personal data to countries outside the EEA.

Notes

⁸ Schedule 4, para. 4(1).

⁹ Information Commissioner's Office Guidance, 'The eighth data protection principle and international data transfers – The Information Commissioner's recommended approach to assessing adequacy including consideration of the issue of contractual solutions, binding corporate rules and Safe Harbor', (Version 3 17.12.08).

CASE REVIEW SECTION

Jefferies International Limited v Landsbanki Islands HF [2009] EWHC 894 (Comm)

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If proceedings are commenced in England pursuant to an exclusive jurisdiction clause against a company domiciled in another Convention State under the Lugano Convention, in what circumstances (if any) is it possible to stay those proceedings permanently under section 49(2) of the Supreme Court Act 1981, or temporarily on a case management basis under Civil Procedure Rule 3.1(2)(f)?

In *Jefferies International Limited v Landsbanki Islands HF* [2009] EWHC 894 (Comm), these questions arose in the context of a disputed debt claim commenced by Jefferies by a claim form issued in the Commercial Court on 18 December 2008. In Iceland, Landsbanki had been placed into a reorganisation procedure on 7 October 2008 pursuant to which its members' powers were assumed by the Icelandic Financial Supervisory Authority and its directors were replaced by a special Resolution Committee. In England, Landsbanki was subjected to a freezing order on 8 October 2008 pursuant to the Anti-Terrorism, Crime and Security Act 2001, but it was licensed to carry on ordinary business activities by HM Treasury.

Landsbanki had applied for a moratorium under Icelandic legislation, which was granted on 5 December 2008, but the relevant provisions of that legislation were repealed by the Icelandic Parliament on 15 April 2009. The case did not therefore touch on the effect to be given to that moratorium under paragraph 5(1) of the Credit Institutions (Reorganisation and Winding Up) Regulations 2004, which provides that '[a]n EEA insolvency measure has effect in the United Kingdom in relation to ... any debt or liability of that credit institution, as if it were part of the general law of insolvency of the United Kingdom.'

In these circumstances, Mr Justice Cooke affirmed the presumption that parties should litigate where they have agreed to litigation and held that departure from that starting point required rare and compelling circumstances. He refused a temporary stay on a case management basis because such a stay would not assist the reorganisation procedure in Iceland and would

in fact place Landsbanki in a better position in England relative to its position in Iceland in which no moratorium was now in force.

Cooke J, applying *Mazur Media Limited v Mazur Media GmbH* [2004] 1WLR 2966, in fact recognised that he had no discretion to permanently stay the proceedings in the circumstances. SCA 1981 s 49(3) entitles a Court to stay proceedings whenever necessary to prevent injustice, but, pursuant to section 49 of the Civil Jurisdiction and Judgments Act 1982, that power is not to be exercised in a way contrary to the Brussels Convention or the Lugano Convention. The position is the same in respect of the Judgments Regulation which is directly applicable without national legislation. The mandatory scheme of jurisdictional rules requires that a Court seized under those rules have no discretion to stay proceedings in favour of a Court of another jurisdiction on forum non conveniens grounds, *Owusu v Jackson* [2005] QB 801.

A Court must, of course, retain control of its own proceedings, and the power to stay proceedings is an essential component of that control. As such, it is important to identify when (if ever) a stay on a case management basis will in substance be a stay contrary to any mandatory jurisdictional rules at hand.

In *CNA Insurance Co Ltd v Office Depot International (UK) Ltd* [2005] EWHC 456 (Comm) at [26(v)], Mr Justice Langley appeared to approach the matter as one of impression:

'The reality is ... that any stay would in its effect be permanent rather than temporary and in substance go to jurisdiction not case management.'

In *Equitas Limited v Allstate Insurance Company* [2008] EWHC 1671 (Comm) at [64], Mr Justice Beatson referred to *CNA Insurance* and noted:

'It was, no doubt, for this reason that Mr Lockey emphasised that the stay he was seeking was temporary and was not an attempt to require Equitas to litigate in another jurisdiction and not in this one.'

Notes

¹ Michael Crystal QC was counsel for the Defendant. Gabriel Moss QC was counsel for the Claimant.

There is, as recognised in *Equitas*, no overlap between case management and jurisdiction. A stay on a case management basis is not the same as a stay of proceedings in favour of proceedings in a Court of another jurisdiction.

It should make no difference whether the case management stay is temporary or (for some exceptional reason) permanent because only a stay in favour of proceedings in a Court of another jurisdiction would be contrary to a mandatory scheme of jurisdictional rules. That the law of the Court seized under those rules may require a permanent stay with the consequence that proceedings cannot be commenced in accordance with those rules in any other Court (without the Court first seized relinquishing jurisdiction) is a consequence of those inflexible rules.

CNA Insurance and *Landsbanki Islands* were cases in which there was no sufficient reason for a case management stay, and so (de facto) any stay would have

been contrary to the mandatory jurisdictional rules at hand. In *CNA Insurance*, Langley J noted that ‘no case management basis for [a stay] has been suggested’, and in *Landsbanki* Cooke J concluded that there was no basis for a case management stay: the proceedings in *Landsbanki* had progressed to a reasonably advanced stage and there was no obvious prospect of the claim being admitted in whole or in part in the reorganisation procedure in Iceland.

There is therefore no obvious scope for a true out-flanking of mandatory jurisdictional rules by a Court exercising its case management powers. A particular set of case management powers is the baggage that comes with litigating in one court rather than another. It is peculiar that a party should ever raise a jurisdictional argument in the face of a reason sufficient to exercise those powers, especially when that Court is one it has chosen.

Cartesio Oktató és Szolgáltató bt (Case C-210/06), ECJ (Grand Chamber), 16 December 2008

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The context

It is now some time since the European Court of Justice (ECJ) ruled in the case of *Eurofood IFSC Ltd*¹ that the presumption contained in Article 3(1) of Council Regulation (EC) 1346/2000 on insolvency proceedings² (the Regulation) – in favour of the registered office as the location of the centre of main interests – may be rebutted only if factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is different from that which locating it at its registered office is deemed to reflect.³ Mobility of a debtor's centre of main interests⁴ (COMI) has also been acknowledged for some time, albeit tempered by the ECJ's judgment in the case of *Staubitz-Schreiber*.⁵ The result is that a debtor company may in principle transfer its COMI to another Member State, by migrating those elements of its administration which determine the location of its COMI, without upsetting the location of its registered office.

The judgment of the ECJ in *Cartesio Oktató és Szolgáltató bt* has brought a speedy end, however, to speculation that national legislation which may restrict the ability of a debtor company to move its COMI to another Member State will be incompatible with EC law. The case concerned the right to freedom of establishment embodied in Article 43 EC. The company (*Cartesio*) sought to transfer its operational headquarters from Hungary to Italy, but wished to remain registered in Hungary. The referring court sought the ECJ's guidance on whether applicable Hungarian legislation, which prevented *Cartesio* from continuing to be governed in accordance with Hungarian law, was compatible with the right of establishment. Were the ECJ to have found such restrictions incompatible with the right of establishment, the consequence would have been to enhance the prospects for companies

incorporated in Member States with similar legislation to migrate their COMI whilst leaving their registered office in the Member State in which the COMI was formerly located.

That was precisely the effect of the Advocate General's Opinion in this case. He deemed such restrictions incompatible with EC law, the effect of which would have been to facilitate the migration of a company's COMI from Member States possessing similar legislation. The ECJ, however, disagreed. It held that such restrictions were not precluded by the right of establishment under EC law. As such, it seems that *Cartesio Oktató és Szolgáltató bt* will not represent a step forward in favour of companies seeking to transfer their COMI to another Member State. Rather, national legislation which denies a company the opportunity to transfer its COMI whilst leaving its registered office behind, is to remain undisturbed.

Factual background and the questions referred

Cartesio was a *betéti társaság* (limited partnership) constituted in accordance with Hungarian law and registered in Baja, Hungary. On 11 November 2005, *Cartesio* applied to the commercial court to amend its registration in the local commercial register. It requested that its seat be amended to '21012 Gallarate (Italy), Via Roma No 16', from the address of its former seat in Baja. That application was rejected.

Under Hungarian law, the place where a company has its central administration must coincide with its place of incorporation. Article 12(1)(d) of Law No. CXLV of 1997 provides that the commercial register must specify the company seat. The seat is defined by Article 16(1) as the place where the company's central administration is situated. By Article 34(1),

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1 Case C-341/04 [2006] ECR I-3813.

2 OJ 2000 L 160, p. 1.

3 At para. [34].

4 Within the meaning of the Regulation.

5 Case C-1/04 [2006] ECR I-701. See also the judgment of Mr. Justice Warren in *Hans Brochier Holdings Ltd v Exner* [2006] EWHC 2594 (Ch).

every transfer of a company seat to the jurisdiction of another court responsible for maintaining the commercial register must be submitted to the court within the jurisdiction of which the company had its former seat. That provision concerns a transfer taking place within Hungary and not an intra-Community transfer.

The commercial court held that Hungarian law did not permit a company to transfer its seat to another Member State whilst retaining its legal status as a company governed by Hungarian law. To change its seat, Cartesio would first have to be dissolved in Hungary and then incorporated under Italian law.

Cartesio appealed against the decision of the commercial court to the Szeged Court of Appeal. On 20 April 2006, that court referred several questions to the ECJ. The first three questions related to various procedural issues arising in connection with Article 234 EC. The referring court then asked whether Articles 43 EC and 48 EC may be interpreted as precluding national legislation which prevented a company incorporated under the law of that Member State transferring its seat to another Member State whilst retaining its status as a company governed by the law of the Member State of incorporation. The following questions were posed:

- (a) If a company, [incorporated] in Hungary under Hungarian company law and entered in the Hungarian commercial register, wishes to transfer its seat to another Member State of the European Union, is the regulation of this field within the scope of Community law or, in the absence of the harmonisation of laws, is national law exclusively applicable?
- (b) May a Hungarian company request transfer of its seat to another Member State of the European Union relying directly on Community law (Articles 43 EC and 48 EC)? If the answer is affirmative, may the transfer of the seat be made subject to any kind of condition or authorisation by the Member State of origin or the host Member State?
- (c) May Articles 43 EC and 48 EC ... be interpreted as meaning that national rules or national practices which differentiate between commercial companies with respect to the exercise of their rights, according to the Member State in which their seat is situated, are incompatible with Community law?
- (d) May Articles 43 EC and 48 EC be interpreted as meaning that, in accordance with those articles, national rules or practices which prevent a Hungarian company from transferring its seat to another Member State of the European Union, are incompatible with Community law?

The issue

Although in responding to the observations of both the referring court and the European Commission, the ECJ considered various other factual scenarios,⁶ the principal issue was narrow. Specifically, whether Articles 43 EC and 48 EC preclude national legislation which prevents a company incorporated under national law from transferring its central administration to another Member State. As stated above, Cartesio had transferred its seat to Italy but wished to retain its status as a company governed by Hungarian law.

Whilst both the Commission and Cartesio submitted that the legislation at issue did place a restriction on the right of establishment and therefore Articles 43 EC and 48 EC applied, several governments (including those of the United Kingdom and Hungary) advanced the contrary view. Those governments contended that the case fell outside the scope of Articles 43 EC and 48 EC altogether.

Opinion of Advocate General Poiares Maduro

In his Opinion handed down on 22 May 2008, Advocate General Poiares Maduro accepted the contentions of the Commission and Cartesio: that the case did not fall outside the scope of Articles 43 EC and 48 EC. He seems to have approached the question from the starting-point of the 'effects' which national rules may have on freedom of establishment and whether those effects conform with the right of establishment under Article 43 EC, rather than from the perspective of whether the substance of those rules fall within the ambit of Articles 43 EC and 48 EC at all.

The Advocate General first analysed Hungarian company law⁷ as: '... [prohibiting] the "export" of a Hungarian legal person to the territory of another Member State'. His opinion was that national rules, which allow a company to transfer its operational headquarters only within the national territory, do treat cross-border situations less favourably than purely national situations.⁸ Further, that such rules

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6 At paras 111-122; see Case C-411/03 *SEVIC Systems* [2005] ECR I-10805 (cross-border merger) and Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) (OJ 2001 L 294, p. 1); Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE) (OJ 2003 L 207, p. 1). In the instant case, however, Cartesio did not wish to change its place of incorporation to Italy and so the ECJ did not consider that the analogies suggested could apply here.

7 At para. [23].

8 At para. [25].

constitute discrimination against the exercise of freedom of movement. By seeking to transfer its operational headquarters to Italy, Cartesio was proposing the 'actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period'.⁹ He concluded that the rules on the right of establishment under Articles 43 EC and 48 EC would apply to such a situation.

In arriving at that conclusion, the Advocate General was forced to reconcile the ECJ's judgment in *Daily Mail and General Trust*.¹⁰ In that case, it was held¹¹ that companies are 'creatures of national law' and 'exist only by virtue of the varying national legislation which determines their incorporation and functioning'. The case thus suggested that 'the terms of the "life and death" of a company are determined solely by the State under whose laws that company was created'. The Advocate General reasoned that the case law on the right of establishment of companies has, however, developed since that time, leading Advocate General Tizzano to observe in his Opinion in *SEVIC Systems*, *op. cit.*:

'It is evident from [the] case-law that Article 43 EC does not merely prohibit a Member State from impeding or restricting the establishment of foreign operators in its territory, it also precludes it from hindering the establishment of national operators in another Member State. In other words, restrictions "on entering" or "on leaving" national territory are prohibited.'

The Advocate General consequently interpreted the ECJ's approach to date as follows:¹²

'... the Court does not, *a priori*, exclude particular segments of the laws of the Member States from the scope of the right of establishment. Rather, the Court concentrates on the *effects* that national rules or practices may have on the freedom of establishment and assesses the conformity of those effects with the right of establishment as guaranteed by the Treaty. As regards national rules relating to the incorporation of companies, the Court's approach is inspired by two concerns. First, in the present state of Community law, Member States are free to choose whether they want to have a system of rules grounded in the real seat theory or in the incorporation theory, and indeed, various Member States have opted for profoundly different rules of incorporation. Second, the effective exercise of the freedom of establishment

requires at least some degree of mutual recognition and coordination of these various systems of rules. The result of this approach is that the case-law typically respects national rules relating to companies regardless of whether they are based on the real seat theory or on the incorporation theory. However, at the same time, the effective exercise of the right of establishment implies that neither theory can be applied to its fullest logical extension...'

He summarised his view as being that a Member State does not enjoy absolute freedom to determine the 'life and death' of companies incorporated under its domestic law, irrespective of the consequences for freedom of establishment. Member States would otherwise have carte blanche to impose a 'death sentence' on a company simply because it had decided to exercise the freedom of establishment. For certain companies an intra-Community transfer of operational headquarters will be an effective form of assuming genuine economic activities in another Member State – without incurring the costs and administrative burdens of first having to wind-up the company and then having to incorporate the company in the destination Member State.

For those reasons he concluded¹³ that: 'Articles 43 EC and 48 EC preclude national rules which make it impossible for a company constituted under national law to transfer its operational headquarters to another Member State'.

ECJ judgment

The Grand Chamber declined to follow the position adopted by the Advocate General. Its starting-point was to consider whether the case fell within the ambit of Community legislation. The ECJ began by determining the circumstances in which a company may rely on the rights embodied in Article 43 EC, by reference to the decided case law of the ECJ (cf. *Überseering*¹⁴). It held¹⁵ that in the absence of a Community law definition of the companies which may enjoy the right of establishment under Article 43 EC, the question whether Article 43 EC applies to a company seeking to rely on the fundamental freedom enshrined in that Article is a preliminary matter which, under the present state of EC law, can only be resolved by the applicable national law. Consequently the question whether the company is faced with a 'restriction on the freedom of

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9 Cf. Case C-221/89 *Factortame and Others* [1991] ECR I-3905 at para. [20].

10 Case 81/87 [1988] ECR 5483.

11 At para. [19].

12 At para. [30].

13 At para. [35].

14 Case C-208/00 [2002] ECR I-9919.

15 At paras [109] et seq.

establishment' within the meaning of Article 43 EC, arises only if it has first been established that the company actually has a right to that freedom.

The ECJ further held that a Member State is entitled to define the connecting factor required of a company if: (i) the company is to be regarded as incorporated under the law of that Member State and as such, capable of enjoying the right of establishment under Article 43 EC; and (ii) the company is to be able subsequently to maintain that status. Accordingly, a Member State is entitled to deny a company its retention of that status if the company intends to move its seat to the territory

of another Member State, thereby breaking the connecting factor required under the national law of the Member State of incorporation.

Accordingly, the ECJ concluded¹⁶ that under the present state of EC law, Articles 43 EC and 48 EC are to be interpreted as '... not precluding legislation of a Member State under which a company incorporated under the law of that Member State may not transfer its seat to another Member State whilst retaining its status as a company governed by the law of the Member State of incorporation'.

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16 At para. [124].

In re Golden Key Ltd (in receivership) [2009] EWCA Civ 636

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In re Golden Key Ltd (in receivership) [2009] EWCA Civ 636, the Court of Appeal determined the proper order of payment to holders of commercial paper ('CP') issued by Golden Key Ltd ('Golden Key').

The case turned on the true construction of the terms of issue. Golden Key was required to redeem CP on its maturity date, but a new redemption date – the Acceleration Redemption Date ('ARD') – would supervene after the occurrence of a Mandatory Acceleration Event ('MAE'), which (if also an Insolvency Event) would cause CP to become immediately due and payable upon receipt by Golden Key of an Acceleration Redemption Notice ('ARN') issued by the Security Trustee.

The facts can be summarised shortly:

- (1) Golden Key was subject to a Mandatory Acceleration Test which required an asset value equal to or exceeding 92 per cent of the face value of its secured obligations.
- (2) On 20 August 2007, Golden Key breached that test, which it confirmed on 23 August 2007.
- (3) The Security Trustee gave notice of an MAE – which was treated by the parties to the litigation as an ARN – on 24 August 2007.
- (4) Golden Key did not specify the redemption date and so, in accordance with certain deeming provisions, the ARD was fixed at 24 September 2007.
- (5) In the period 23 August to 24 September 2007, CP matured such that an issue arose as to the proper order of payment, specifically whether CP maturing and unpaid on or after 23 August 2007 was now postponed and repayable on 24 September 2007.

Parties C and D (the 'Longs') – appointed as representative respondents on the application of the receiver of Golden Key – contended that such CP was now repayable on 24 September 2007. In effect, a *pari passu* distribution. Parties A and B (the 'Shorts'), by contrast,

argued that acceleration only affected CP whose maturity date had not arrived by that date and they were entitled to repayment on the basis of first come, first served. In effect, a 'pay as you go' construction.

The Court of Appeal upheld the 'pay as you go' construction favoured by Mr Justice Henderson, but differed as to the proper effect of the delivery of an ARN.

The case is, on one view, of no general importance whatsoever because it turned on the terms of issue, but, on another view, it represents a refinement of the principles applicable to the construction of sophisticated commercial documents. This division is reflected in the judgments of Lord Clarke MR (paragraph 148) and Lady Justice Arden (paragraph 2). Lord Justice Lloyd did not comment on this point.

This case note outlines the judgments in the Court of Appeal and considers whether there has in fact been (or should be) any refinement to the proper approach to construction.

Henderson J

Before Henderson J, the Shorts had submitted that holders of CP which matured in the intermediate period acquired an immediate right to repayment in full and that this was not affected by either the occurrence of a MAE or the delivery of an ARN.

In reply, the Longs had submitted that because a MAE had occurred all outstanding CP fell due to be repaid *pro rata* and *pari passu* on the ARD.

Accordingly, the issue to be determined divided into two questions:

- (1) What event triggered acceleration, specifically –
 - (a) the occurrence of an MAE.
 - (b) the delivery of an ARN, or
 - (c) the fixing of an ARD?
- (2) What was the effect of acceleration on matured CP?

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¹ Mark Phillips QC and Tom Smith were counsel for Parties C and D. Antony Zacaroli QC was counsel for Party A. Robin Dicker QC and Barry Issacs were counsel for the receivers.

Henderson J accepted the argument of the Shorts. Having regard to sections 7.3 to 7.5 of the Collateral Trust and Security Agreement, he explained, at paragraphs 97 and 98 of his judgment, that the ARD was the relevant event but that it did not impact on accrued, vested rights:

‘The Post-Wind Down Priority of Payments ... applies only upon the occurrence of an Acceleration Redemption Date. It does not apply from the occurrence, or notification, of a Mandatory Acceleration Event, although those events are necessary precursors of an Acceleration Redemption Date. It seems clear, therefore, that the scheme of the CTSA, for better or for worse, is that distribution on a *pro rata* and *pari passu* basis applies only to funds received or recovered by the Security Trustee on or after the Acceleration Redemption Date.’

In respect of the first question above, Arden LJ regarded the Judge’s reasoning as ‘potentially circular’ (paragraph 36). The question was whether the maturity date of any CP was accelerated or postponed. The fact that payment has to be made on the ARD did not touch on the question of whether there will be a suspension of payments in the meantime.

Arden and Lloyd LJ moreover considered the Judge’s construction uncommercial because the fixing of the ARD turned on the action or inaction of Golden Key which, at the relevant time, would be a party in default of its obligations (paragraphs 39 to 42, and 123 to 125).

There was no explanation in the evidence as to why Golden Key had such a discretion except that ‘[t]his flexibility appears to be for purposes of administrative convenience, and in particular to allow [Bank New York Mellon] and [Depository Trust Corporation] to redeem the Notes in an orderly fashion’ (paragraph 112).

On this evidence, Lloyd LJ concluded:

‘I cannot think of any reason why a provision whose only identified purpose is that of administrative convenience should have a substantive effect on priorities as between creditors in circumstances such as those prevailing in the present case. It seems to me all the more absurd, and therefore unlikely to have been intended, that such a provision should have that effect where it is left to the debtor to decide (within a prescribed range) what is the relevant date.’

The credible choice as to the trigger for acceleration was therefore between the ARN and MAE. Having regard to the precise mechanism by which an MAE was to be declared, Arden and Lloyd LJ did not consider an MAE to be too uncertain a trigger but, on reflection, held that redemption was accelerated upon delivery of an ARN (paragraphs 53 and 117).

In respect of the second question, Arden and Lloyd LJ agreed with the Judge that clear language was

required to take away an accrued, vested right to payment (paragraphs 61 and 128). Arden LJ explained, at paragraph 64 of her judgment, that:

‘In those circumstances, I consider that an ARN can only postpone redemption of CP where the Maturity Date has not arrived on or before the date on which the ARN is delivered.’

Accordingly, the Court of Appeal dismissed the Long’s appeal on the condition that a minute of order be drawn up varying the Judge’s order.

A refined approach?

Was any special approach to construction required to reach this conclusion?

In rejecting a *pari passu* construction of the terms of issue, Henderson J had acknowledged, at paragraph 98 of his judgment, that:

‘The point that one might expect to find machinery for *pari passu* distribution once insolvency is imminent has force ... but ... less force than in many commercial contexts precisely because the parties have all agreed to sign up to an investment structure which is “insolvency remote”. In those circumstances, it is dangerous to start with assumptions about what the parties must or are likely to have intended, and there is in my judgment no substitute for a close examination of the language of the contractual terms in order to ascertain what their rights may be.’

These observations, on their face, are consistent with the ordinary principles of contractual construction, but Arden LJ, concerned that such observations might be interpreted as favouring a narrow, textual approach (paragraph 30), addressed two matters in her judgement –

- (1) ‘the proper weight to be given to the commerciality of a particular interpretation’ (paragraph 25) and,
- (2) specific to the context of insolvency, the proper role of the concept of *pari passu* distribution as a ‘factor’ informing construction (paragraph 6).

The general rule of contractual construction is, of course, well-established. It requires the Court to ascertain the meaning a document would convey to a reasonable person having all the relevant background knowledge which would reasonably have been available to the parties in the situation in which they were at the time the contract was made: *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, 912; and *BCCI v Ali* [2002] 1 AC 251, 296.

In carrying out this task, Arden LJ considered that the Court ‘must have regard to the parties’ aim, objectively

ascertained ... if that aim can be ascertained' (paragraph 27) and it must do so even where 'there is little evidence as to the circumstances surrounding the parties' agreement to the transaction other than the terms of the transaction itself' (paragraph 28).

As such, it is difficult to disagree with the submission of Party A that recourse to 'the commercial expectations of the parties' is meaningless where there is no evidence as to the expectations of the parties other than the contents of the documents under consideration.

The basis for a 'presumption' (paragraph 29) about what the parties did or did not intend can in fact only flow from the relevant background knowledge attributed to them because a presumption is something drawn from wider experience.

In this respect, Arden LJ considered that, in the context of insolvency or an analogous situation, the concept of *pari passu* distribution – a default rule of rateable distribution that yields to contrary intention (paragraphs 3-5) – was of such 'importance' that it

'can be taken to be part of the background to the issue of the CP that would have been known to the parties' with the consequence that it 'may also be a factor which makes one interpretation more plausible than another' (paragraph 6).

Such attribution is difficult. The concept of *pari passu* distribution yields to contrary intention. For this reason, its use in working out that intention is far from obvious. Its use, in effect, favours at the outset one rival construction over another. It is not clear why this should be the case where the very agreement disputed is a departure from the default rule.

For this reason it is submitted that the approach of Lord Clarke MR, like the approach of Lord Neuberger *In Re Sigma Finance Corporation* [2008] EWCA Civ 1303, is the better approach, and in any event, it is not obvious what practical difference would flow from a refined approach. Lloyd LJ expressed no novelty in construing the terms of issue and yet concurred entirely with Arden LJ.

CASE REVIEW SECTION

(1) Jozef Syska (2) Elektrim SA v (1) Vivendi Universal SA (2) Vivendi Teleom International SA (3) Elektrim Telekomunikacja Sp z.o.o. (4) Carcom Warszawa Sp z.o.o. [2009] EWCA Civ 677

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Introduction

Where an arbitration is proceeding in one Member State of the European Union and one of the parties to the arbitration becomes insolvent in another Member State, are the consequences of that insolvency, in so far as they affect the arbitration, to be determined by the law of the Member State where the insolvency proceedings have been instituted or the law of the Member State in which the arbitration is taking place?

The Court of Appeal heard an appeal from a judgment of Christopher Clarke J ([2008] EWHC 2155 (Comm), now reported at [2008] 2 Lloyd's Rep 636). In that decision the judge had held that, where main insolvency proceedings had been opened in Poland, but arbitration proceedings had already been pending in England at the date of insolvency, then the effects of the insolvency on the arbitration agreement were governed by the law of England (the Member State in which the arbitration was pending) rather than the law of Poland (the Member State in which the insolvency proceedings had opened).

Background

Elektrim SA, the second claimant and appellant ('Elektrim') was a Polish company, which at one time owned a substantial shareholding in PTC, a Polish mobile telephone company.

On 3 September 2001 Elektrim entered into an agreement known as the Third Investment Agreement ('TIA') with Vivendi Universal SA and Vivendi Telecom International SA, the first and second respondents (together 'Vivendi'). This was one of a series of agreements whereby Vivendi was intended to acquire an interest in PTC. Article 5.11 (c) of the TIA contained an agreement to arbitrate (the 'Arbitration Agreement') which provided for arbitration in London under LCIA rules. It was common ground between the parties that the arbitration agreement was governed by English law (although the rest of the TIA was governed by Polish law).

On 22 August 2003 Vivendi commenced arbitration pursuant to the Arbitration Agreement. In the arbitration Vivendi advanced claims that Elektrim had breached its obligations under the TIA by interfering with, or failing to secure, the interest that Vivendi was supposed to obtain in PTC. In early 2007, the LCIA arbitral tribunal fixed a hearing on liability issues for 15-19 October 2007. The claims made were in the order of EUR 1.9 billion.

Meanwhile, on 21 August 2007, Elektrim was declared bankrupt by an order of the Warsaw District Court pursuant to its own petition of 9 August 2007. As a result of that order, Elektrim became a 'bankrupt' for the purposes of Polish law. The order of 21 August 2007 of the Warsaw District Court (a) declared that Elektrim was bankrupt, (b) appointed Jozef Syska (the first claimant) as Court Supervisor and (c) provided for Elektrim's own management to retain control of all of Elektrim's assets and to take any actions within the ordinary scope of its business. On 5 February 2008, the Warsaw Court appointed Mr Syska as the administrator over Elektrim's assets.

On 22 August 2007, Elektrim wrote to the Tribunal and Vivendi saying that, as result of the bankruptcy, the Arbitration Agreement had been annulled pursuant to Article 142 of the Polish Bankruptcy and Reorganisation Law. This provides that: 'any arbitration clause concluded by the bankrupt shall lose its legal effect as at the date bankruptcy is declared and any pending arbitration proceedings shall be discontinued'. On 15 October 2007, the scheduled arbitration hearing began in London. At that hearing, the Tribunal heard argument from both parties as to whether the arbitration agreement had been annulled. On 20 March 2008, the Tribunal issued an Interim Partial Award (the 'Award'). The Tribunal by a majority rejected Elektrim's objections to their jurisdiction and declared that Elektrim had breached the terms of the TIA.

On 2 October 2008 Christopher Clarke J handed down his judgment, rejecting the claimants' application under section 67 of the Arbitration Act 1996 to set aside the Award on the ground that in accordance with Polish bankruptcy law the judgment had lost its

legal effect as at the date bankruptcy was declared. Since the judgment, the Tribunal had rendered a final award dated 12 February 2009 by which it awarded (1) damages to the first respondent in the amounts of EUR 1,670,180,000 and EUR 38,971,000 and (2) damages to the second respondent in the amounts of EUR 166,871,000 and EUR 600,000 (the 'Final Award').

Applicable law

The question of whether the consequences of insolvency proceedings in one Member State, in so far as they affect arbitration proceedings in another Member State, are to be determined by the law of the former or the latter fell to be determined with reference to the EC Insolvency Regulation (the 'Insolvency Regulation').

Article 4 (1) of the Insolvency Regulation provides that:

- (i) Save as otherwise provided in this Regulation, the law applicable to insolvency proceedings and their effects shall be that of the Member state within the territory of which such proceedings are opened, hereafter referred to as the 'State of the opening of proceedings';
- (ii) The law of the State of the opening of proceedings shall determine the conditions for the opening of those proceedings, their conduct and their closure ...

Article 4 (2) then gives a non-exclusive list of the examples of matters which the law of the state of the opening of proceedings is to determine. Two examples are:

- (e) the effects of insolvency proceedings on current contracts to which the debtor is party;
- (f) the effects of insolvency proceedings on proceedings brought by individual creditors, with the exception of lawsuits pending.

Article 15 further provides that:

'The effects of insolvency proceedings on a lawsuit pending concerning an asset or right of which the debtor has been divested shall be governed solely by the law of the Member State in which the lawsuit is pending.'

The first instance decision

The judge at first instance had held that there was a conflict between the general provision in Article 4, which declared that the law of the opening of proceedings ('*lex concursus*') was the law applicable to insolvency proceedings, and the 'special' or 'particular'

exception that the effects of insolvency proceedings on pending lawsuits or references to arbitration should be governed solely by the law of the Member State in which that lawsuit or reference was pending on the other hand.

There was no provision of English law annulling the Arbitration Agreement. The fact that Article 4 (2)(e) would apply Polish law to 'current contracts' (including the agreement to arbitrate) made no difference because it was only an example of the general provision, and it had to yield to the specific provision

The submissions

On appeal Counsel for the appellants contended that the judge had been wrong to say that Article 4 and Article 15 were in conflict. He made the following submissions:

- (a) Article 4 was the primary article both chronologically and as a matter of construction of the Insolvency Regulation.
- (b) Article 4 particularly applied to 'current contracts' and that must include current agreements to arbitrate.
- (c) The *lex concursus* therefore determined the effects of the insolvency proceedings on the agreement to arbitrate.
- (d) The agreement to arbitrate must, therefore, be regarded as annulled or void from the date of the bankruptcy.
- (e) The pending reference could not have any independent existence once the agreement to arbitrate ceased to have effect.
- (f) The arbitrators therefore had no jurisdiction to proceed.

The judgment

In his leading judgment, Longmore LJ made the following initial observations:

- (a) It is not difficult to see why pending lawsuits should be excluded from the general application of the *lex concursus* set out in Article 4. If a legal action has begun or a reference to arbitration has been constituted in a Member State, it is natural that it should be the law of the Member State where the legal action has begun or the reference to arbitration is taking place which should determine whether or not that action or reference be continued or not.
- (b) If no claim has begun before insolvency proceedings are opened, it is appropriate that the *lex concursus* should determine how any subsequent litigation or arbitration should proceed. But if

litigation or arbitration has begun before insolvency occurs, the natural expectation of business would be that it should be that law that should determine whether the proceedings should continue or come to a halt.

- (c) These considerations are reflected in recitals 23 and 24 of the Insolvency Regulation. The latter provides that: 'automatic recognition of insolvency proceedings to which the law of the opening State normally applies may interfere with the rules under which transactions are carried out in other Member States. To protect legitimate expectations and the certainty of transactions in Member States other than that in which proceedings are opened, provisions should be made for a number of exceptions to the general rule'.

Though his Lordship agreed that Article 4 and Article 15 are not really in conflict, he held that once it is accepted that 'lawsuit pending' includes pending references to arbitration, it must be Article 15 that is the relevant and appropriate Article. For that reason, one cannot say that Article 4 is 'primary' to Article 15: each article has its own sphere of operation, and once it is clear that there is a 'lawsuit pending' the question of whether that lawsuit should be continued by reason of the insolvency is to be determined solely by English law as 'the law of the Member State in which the lawsuit is pending'.

His Lordship referred to paragraph 142 of the Virgos-Schmidt report (which would have been the

Official Report of the bankruptcy Convention had one ever been agreed). This paragraph draws a distinction between proceedings by way of execution (governed by the *lex concursus*) and proceedings (lawsuits) to establish liability (governed by the law of the Member State where such proceedings are under way).

For these reasons, Longmore LJ decided that the question whether pending lawsuits should be continued in the light of insolvency is to be determined by the law of the Member State in which those proceedings are pending, and dismissed the appeal.

Comments

It was generally accepted that 'lawsuit pending' (referred to in Article 15) included references to arbitration, and that arbitration fell within Article 15, which acted as an exception to Article 4. Consequently English law applied to the effect of Elektrim's bankruptcy on the arbitration proceedings.

However, if no claim is instituted before the onset of insolvency proceedings, then it is appropriate that the *lex concursus* should determine how any subsequent litigation or arbitration should proceed. The practical effect of this is that, when considering arbitration against a party that is or is about to become insolvent, thought should be given to the likely effect of any such insolvency on the arbitration, and whether arbitration should be instituted *before* the formal opening of main proceedings.

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