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ARTICLE

Recent Application for Permission to Bring Judicial Review Proceedings Challenging the Validity of the Financial Collateral Arrangements (No. 2) Regulations 2003

Mark Griffiths, Associate, and **Helen Liu**, Legal Assistant, Restructuring Group, Orrick Herrington & Sutcliffe, London, UK

The validity of the Financial Collateral Arrangements (No. 2) Regulations 2003[1] (the 'Regulations') was recently challenged by Cukurova Finance International Limited ('CFI') and its parent Cukurova Holdings AS ('CH') (together 'Cukurova') in the case of *R (on the application of Cukurova Finance International Ltd and another) v HM Treasury*.[2] Cukurova applied to the Administrative Court of the High Court of England and Wales for permission to bring judicial review proceedings challenging the validity of the Regulations.

The Regulations implement the Financial Collateral Directive[3] (the 'Directive') and came into force in England and Wales on 26 December 2003. The purpose behind the Directive was to ensure that Member States adapted their national laws in order to facilitate the provision and receipt of financial collateral in circumstances where such collateral is part of a 'financial collateral arrangement'. However, although the Directive concerned certain transactions involving the use of financial collateral, the scope of the Directive is limited as its purpose is to provide only a 'minimum regime'.

Cukurova sought permission to challenge the *vires* (or legality) of the Regulations on the grounds that section 2(2)(b) of the European Communities Act 1972 (the '1972 Act') did not confer power on Her Majesty's Treasury to make the Regulations. This was on the basis that the Regulations enlarge the personal application of the provisions beyond the scope of the Directive and thus in contravention of section 2(2)(b) of the 1972 Act. Accordingly, Cukurova argued, they should be quashed or, alternatively, construed so as to be *intra vires* (or within the confines of the Directive).

The issue: validity of the extension to the Directive by the Regulations

The Regulations were made for the purpose of implementing the Directive but they also extended the scope of the Directive. Whereas the Directive was confined to financial collateral arrangements made between non-natural persons and specified financial institutions, the Regulations extended the provisions of the Directive to cover financial collateral arrangements transacted between non-natural persons, neither of whom needed to be specialised financial institutions.

Background: *Alfa Telecom Turkey Ltd v Cukurova Finance International Ltd and Cukurova Holdings AS (BVI)*[4]

The challenge by Cukurova in the Administrative Court to the validity of the Regulations was part of ongoing litigation between Cukurova and Alfa Telecom Turkey Ltd ('Alfa') originally commenced in the British Virgin Islands ('BVI').

Alfa had loaned Cukurova USD 1.352 billion (the 'Loan') which was secured by equitable charges over shares (the 'Charged Shares') in certain subsidiaries (the 'Share Charges'). Two of the Share Charges were governed by English law and two were governed by BVI law. They provided that Alfa had the right, on enforcement of the Share Charges, to appropriate the Charged Shares to discharge the liabilities owed to it under the Loan.

On 16 April 2007, it was alleged by Alfa that Cukurova had committed a number of 'events of default' under the terms of the Loan and Alfa demanded

Notes

1 SI 2003 No. 3226.
2 *R (on the application of Cukurova Finance International Ltd and another) v HM Treasury* [2008] EWHC 2567.
3 Directive 2202/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.
4 BVI Judgment on *Alfa Telecom Turkey Ltd v Cukurova Finance International Ltd and Cukurova Holdings AS*, HCVAP 2007/027.

immediate payment of the balance of the Loan plus interest. On the same day, 16 April 2007, Alfa commenced legal proceedings in the BVI seeking an order requiring the repayment of the Loan and also seeking orders requiring Alfa to be registered as holder of the Charged Shares.

On 27 April 2007, the parties undertook the following action: (i) Alfa presented the share certificates and stock transfer forms for the Charged Shares to Cukurova's respective registered agents in BVI (in this case CFI and Cukurova Telecoms Limited); (ii) CH and CFI issued Stop Notices before the BVI Court Registry; and (iii) Alfa sent letters to CFI and CH claiming that it was exercising its right to appropriate the Charged Shares with immediate effect.

The question arose before the BVI court as to whether or not Alfa had the power to appropriate the Charged Shares and, if so, whether such power had been effectively exercised by Alfa. On 22 April 2008, the Court of Appeal for the Eastern Caribbean reversed the first instance decision (which had been given on 16 November 2007) and found that the Charged Shares were validly appropriated by Alfa. It held that: (i) it was sufficient that the equitable mortgagee (Alfa) became the absolute owner of the equitable (rather than the legal) interest in the Charged Shares; (ii) the Regulations expressly gave the power of appropriation, if the parties so agreed, to the holder of an equitable mortgage of collateral; and (iii) it was sufficient for the equitable mortgagee (Alfa) simply to form the intention to appropriate (for instance, by agreement), or to keep as absolute owner, the collateral.

The forming of that intention, coupled in this case with notification of appropriation to the equitable mortgagor (Cukurova), was effective to appropriate the collateral. Thus the Court of Appeal for the Eastern Caribbean ultimately ruled that the Charged Shares had been lawfully appropriated by Alfa holding that it is not necessary for a charge holder under an English law governed share charge to be registered as the legal owner of those shares in order to exercise the power of appropriation under the Regulations. Cukurova appealed this decision to the Privy Council and this appeal is pending.

Alfa did not initially raise as an issue the question of the validity of the Regulations. When the issue was raised, the BVI court (on 25 September 2007) declined to rule on a challenge to the validity of the Regulations introduced by a foreign state. Cukurova brought separate judicial review proceedings in the Administrative Court of the High Court of England and Wales.

R (on the application of Cukurova Finance International Ltd and another) v HM Treasury

Cukurova brought separate proceedings in the Administrative Court by application dated 4 December 2007 and applied for permission to challenge the validity of Regulations by way of judicial review. This was on the basis that whilst the Regulations were made for the purpose of implementing the Directive, they did in fact extend the scope of the Directive.

The Directive was limited to financial collateral arrangements made between non-natural persons and 'specified financial institutions' – namely persons identified in the Directive. The Regulations extended the provisions of the Directive to cover financial collateral arrangements transacted between non-natural persons, neither of whom were specialised financial institutions (i.e. not a financial institution, public body nor any other entity falling within the scope of Article 1(2)(a)-(d) of the Directive).

Therefore, Cukurova sought to challenge the Regulations on the basis that the Directive had been extended beyond the scope of the power conferred by section 2(2)(b) of the 1972 Act and that the Treasury had therefore acted *ultra vires*. Section 2(2) of the 1972 Act states that secondary legislation (such as the Regulations) may be made only: (a) for the purpose of implementing any Community obligation in the United Kingdom or enabling any such obligation to be implemented or of enabling any rights enjoyed or to be enjoyed by the United Kingdom under or by virtue of the treaties to be exercised; or (b) for the purpose of dealing with matters arising out of or related to any such obligation or rights or the coming into force or the operation from time to time, of section 2(1) (which effectively gives legal effect to Treaties whether implemented or not).

Timing of the application

The first issue was to consider the date the grounds of the challenge first arose. Lord Justice Moses stated that the grounds for making the challenge arose when, as was alleged, the Regulations were unlawfully made or came into force. Accordingly, the proceedings had neither been made promptly nor in any event not later than three months after the grounds to challenge the Regulations first arose (as required by Civil Procedure Rules ('CPR'), 54(5)).

The Regulations were made on 10 December 2003, the majority of which came into force on 11 December 2003 (the remainder coming into force on 26 December 2003). Therefore, the time for bringing the application had expired and the application was out of time. It was at the court's discretion as to whether or not it should extend time pursuant to CPR 3.1.

Implications of granting permission for judicial review

The court found that the issue was clearly of public importance as the extension of the provisions of the Directive to financial collateral arrangements where both parties are non-natural persons, but neither is a

specified financial institution, represented a significant inroad into the rights of unsecured creditors in insolvency. However, the courts found that Cukurova's application had been subject to significant undue delay and that it would be impossible to ascertain the effect on commercial transactions which had been entered into in reliance on the validity of the Regulations (if the Regulations were found to be *ultra vires*).

Should the Regulations be quashed, then the court considered that the effect of this would be to put the United Kingdom in breach of its Community obligation to give effect to the Directive. Whilst it was not required to consider this point further (as the parties accepted that relief should be sought on the alternative basis), the court, understandably, showed reluctance in following this line of reasoning.

Cukurova's alternative argument was to seek relief limited to what it argued was the overextension of the personal scope of the Directive. Whilst the court acknowledged the undoubted importance of the issue, it stated that two factors were strongly persuasive in not granting an extension:

(a) The reliance placed by market participants on the validity of the Regulations since December 2003. There had been a delay of over four years in bringing the application, during which the Regulations had not been challenged in any court. A substantial number of financial collateral arrangements would have been made during that period. A number of non-natural persons would have entered into financial collateral arrangements in reliance on the validity of Regulations and on the lawfulness of the remedy of appropriation provided under it.

(b) Furthermore, Cukurova had obtained a commercial advantage by having, in part, assumed that the Regulations were valid. Cukurova, in return for a loan of USD 1.352 billion in 2005 from Alfa, was prepared to accept (at least in part) that in the event of default, Alfa would be entitled to appropriate the Charged Shares. Therefore, for the purpose of gaining the commercial advantage of the Loan, it had in part assumed the validity of the Regulations. This was a significant factor against the granting of an extension and would have required Cukurova, at the very least, to take quick and effective measures to make its challenge to the *vires* of the Regulations rather than delay until December 2007, over seven months after the purported appropriation.

The judge also considered the stability of the financial markets generally as an important factor in not granting an extension to the time limit pursuant to CPR 3.1.

Merits of Cukurova's claim: are the Regulations *ultra vires*?

Although the court did not make a decision based on the merits it did consider this issue. This was because a court would grant an extension despite undue delay where the merits are so strong that the court senses that a grave injustice will result were permission refused on the grounds of delay.

However, after consideration the court concluded that the arguments advanced by Cukurova were 'far from being of sufficient strength to [reach] the conclusion that justice demands an extension of time'.[5] The court found that the Regulations widen the protection afforded to financial collateral arrangements and thus add to the stability of the financial markets. The Regulations avoid the difficulty in drawing the distinction between the wholesale and other financial markets. The court therefore concluded that Cukurova's prospects of success were not such as 'to demand an extension of time to avoid almost inevitable justice'.[6]

Conclusion

Clearly, although Cukurova's attempt to challenge the validity of the Regulations has been unsuccessful, the issue has not yet been finally resolved and could be raised again by another party at a future date. Whilst this residual uncertainty as to the validity of the Regulations is unhelpful for market participants as it prevents parties from accurately pricing credit risk, in reality, it is unlikely that a court will decide that the Regulations, or indeed any part of the Regulations, is *ultra vires*.

Recognising the importance of this issue, the Government has, however, acted to remove the uncertainty by including a number of provisions relating to financial collateral arrangements in proposed primary legislation in the United Kingdom (the Banking Bill 2008).[7]

Notes

5 See note 2, para. 102.
6 *Ibid.*, para. 104.
7 Introduced on 7 October 2008.

International Corporate Rescue

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