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ARTICLE

The Vultures are Circling: The High Court Defines 'Financial Institution' Widely

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Introduction and synopsis

In the recent judgment handed down by HHJ Pelling QC, *Grant and Others v WDW 3 Investments Ltd and another [2017] EWHC 2807 (Ch)*, the High Court considered whether a financial instrument had been validly assigned. The court held that where the parties had not agreed a definition of 'financial institution' in a commercial loan agreement, such term would be construed broadly. The court concluded that a special purpose entity set up to extract value from distressed debt, commonly known as a 'vulture fund', fell within this wide construction.

The facts

Olympia Securities Commercial plc (in administration) (the 'Company') and Irish Bank Resolution Corporation Limited ('IBRC') entered into a facility agreement under which IBRC agreed to lend the Company in excess of GBP 50 million (the 'Facility Agreement'). The Facility Agreement was subsequently varied on a number of occasions. The relevant iteration of the Facility Agreement, entered into in December 2009, was supported by various interest rate swaps and secured by a debenture.

The Facility Agreement contained a provision that allowed IBRC to assign its rights under the agreement to 'to any one or more banks or other financial institutions'. Crucially, 'financial institution' was not defined in the Facility Agreement.

The Minister of Finance of the Republic of Ireland placed IBRC into special liquidation in February 2013, which would have entitled the Company to terminate the swaps. However, the Company elected not to do so. A year later, IBRC, acting by its special liquidators, agreed to sell parts of its loan book, including the rights under the Facility Agreement, to LSREF III Wight Limited ('LSREF').

Prior to completion of the sale of the loan book, LSREF set up a subsidiary, WDW 3 Investments Limited ('WDW'), with a GBP 1 share capital. WDW was assigned all of IBRC's rights under the Facility Agreement as LSREF's nominee. In addition, IBRC assigned its rights under the debenture to WDW, and LSREF agreed with IBRC that all or any rights or liabilities arising in respect of the swaps would accrue to or be borne by LSREF notwithstanding that IBRC remained the Company's counterparty.

In June 2014, the Company missed the deadline for repayment of the loan, which was an event of default under the Facility Agreement. WDW accelerated the loan and in July 2014 the special liquidators of IBRC terminated the swaps and served an early termination payment notice on the Company.

The High Court decision

The issues for the High Court were:

- whether the assignment of the Facility Agreement was valid, which depended on whether WDW was a 'financial institution' under the Facility Agreement;
- whether IBRC was entitled to terminate the swaps; and
- whether, when the early termination payment became payable, it was secured by the debenture.

The judgment (at paragraphs 13 to 15) provides an excellent summary of the current principles of contractual interpretation, drawing on recent Supreme Court guidance in *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50, *Arnold v Britton* [2015] UKSC 36 and *Wood v Capita Insurance Services Limited* [2017] UKSC 24.

In its assessment of whether WDW was a 'financial institution' under the Facility Agreement, the High Court looked to the Court of Appeal decision in *The Argo Fund Ltd v Essar Steel Ltd* [2006] EWCA Civ 241. This decision was made in the context of a syndicated loan agreement that was sold on the secondary debt market. In the majority speech in that case, Auld LJ stated that it was not necessary for a 'financial institution' to undertake bank-like activities, such as the lending of money on the primary or secondary lending market, nor was there a need for the entity to show a standard of suitability or probity as a financial institution. There

was no need for it to be subject to particular regulatory regimes.

HHJ Pelling QC recognised that the *Argo* decision had been made in a different commercial context given that it related to a syndicated loan agreement and not a commercial loan agreement. However, he noted that the contextual difference was slight, and concluded that he should not depart from the Court of Appeal's approach.

In following *Argo*, HHJ Pelling QC found (paragraph 21) that the true meaning of the phrase 'financial institutions' was that to be such an institution the entity concerned must be 'a legally recognised form or being, which carries on its business in accordance with the laws of its place of creation and whose business concerns commercial finance'. It was not necessary for an entity to be 'operating on its own behalf in the field of regulated finance' to be a financial institution as long as its 'business concerns commercial finance'. The concept was intentionally widely drawn and will, for example include commercial trust corporations, primary and secondary lenders, and those who act as agents, trustees or fiduciaries either for buyers or borrowers on one side of a transaction or for the providers of services on the other. It would also include those who provide managerial services on behalf of the providers or users of financial products and services.

On this analysis, WDW was therefore clearly within the scope of what counts as 'financial institution'. The respondents however argued that WDW would still be outside of this definition because:

– it had a share capital of GBP 1;
– it was not trading at the time of assignment; and
– it was a 'vulture fund', not regulated and possibly be expected to take a more aggressive approach to enforcement.

The court dismissed all three arguments. As regards the share capital, it was difficult for a court to draw an arbitrary definition of the size of share capital needed to be a 'financial institution' when the parties had not done this contractually. In any case, there was not necessarily a connection between share capitalisation and trading volumes. Moreover, to adopt a threshold of share capital would necessarily exclude partnership models from the definition.

In relation to the non-trading argument, HHJ Pelling QC asserted that introducing the requirement of being a trading entity would create an artificial situation where a newly-incorporated entity would not be a 'financial institution' on incorporation, but it would fall under the definition immediately on entering into a single nominal transaction.

Finally, as regards the 'vulture fund' arguments, the fact that an entity is not regulated is of no relevance as long as it is carrying on its business in accordance with the laws of its place of creation (and there was no suggestion here that this was not the case). As regards the increased likelihood of aggressive enforcement, this was not made out on the facts but a mere assertion. In any event, if this was a true concern the Company could and should have negotiated a more restrictively drawn non-assignment provision.

Therefore, as WDW was within the definition of 'financial institution' the Facility Agreement had been validly assigned from IBRC to WDW.

The second issue in relation to whether IBRC was entitled to terminate the swaps in July 2014 regardless of its own previous event of default turned on the construction of clause 6(a) of the ISDAMA (early right to termination). HHJ Pelling QC found that neither party was obliged to terminate on an event of default, and therefore the Company acted correctly in not terminating earlier. However, despite IBRC's own default on entering into special liquidation, it could legitimately terminate on the Company's subsequent event of default.

The third issue concerned assignment of the benefit of the debenture, which had been validly made on the facts.

Comment

The first issue arose because the term 'financial institution' was not defined in the Facility Agreement.

Following *Argo*, the High Court took an expansive view of the term. As this case demonstrated, the definition of 'financial institution' extends to entities commonly known as 'vulture funds'. Such funds may aggressively pursue distressed debt purchased on the secondary market, although the judge noted that this was a mere assertion and not proven. If the term is used (and not otherwise defined) it could also capture other problematic entities, such special purpose vehicles set up by competitors to strategically escalate distressed debt.

The case serves as useful reminder for parties to carefully check what terms ought to be defined at the outset and to ensure, in particular, that if a borrower wishes to have restrictions on the assignment of the debt, these need to be addressed at the outset in the contract. The court was clear that it had been open to the Company to provide a definition of the term and thereby introduce limits to the assignability of the debt – it had either chosen or failed to do so and now had to live with the commercial consequences of its inaction.

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