"Financial" pledges of monies deposited in accounts after the opening of insolvency proceedings

(Commentary to the Judgment of the Court of Justice of the European Union of 10 November 2016 in Case C-156/15)

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The Court of Justice of the European Union (CJEU) has just made a pronouncement on three of the most important matters open to interpretation concerning the regime applicable to financial collateral arrangements under Directive 47/2002 of the European Parliament and of the Council of 6 June 2002.

1. In its judgment of 10 November 2016 (Case C-156/15), the CJEU gives a preliminary ruling on questions referred to it concerning the interpretation of Directive 2002/47/EC on financial collateral arrangements. The case has its roots in a deposit account governed by the laws of Latvia that contains a clause according to which monies deposited at any time in the account constitute the subject matter of financial collateral pledged to the bank, covering any and all of the bank's claims against the guarantor. In the case under consideration, several months after the account holder - a commercial company - was made insolvent, the bank debited LVL 192.30 (approximately EUR 274) as account maintenance fees for the period up to the opening of insolvency proceedings. The insolvency administrator claimed that such charge constituted a breach of the principle of equal treatment of insolvency creditors, but the Latvian courts of first instance and appeal relied on the national transposition of Directive 47/2002, which excludes financial collateral from the scope of insolvency law, to reject restitution. The Latvian Supreme Court, however, refers several questions for a preliminary ruling to the CJEU.

2. The judgment states that "Directive 2002/47 is to be interpreted as conferring on the taker of financial collateral, such as the collateral at issue in the main proceedings, whereby monies deposited in a bank account are pledged to the bank to cover all the account holder's debts to the bank, the right to enforce the collateral, notwithstanding the commencement of insolvency proceedings in respect of the collateral provider, only *if, first, the monies covered by the collateral were deposited in the account in question before the commencement of those proceedings* or those monies were deposited on the day of commencement, the bank having proved that it was not aware, nor should have been aware, that those proceedings had commenced *and, second, the account holder was prevented from disposing of those monies after they had been deposited in that account*".

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3. In essence, the judgment rests on three postulates:

   a) Directive 47/2002 does not limit its application to collateral provided under payment and securities settlement systems. The CJEU confirms that the words "obligations … which give a right to cash settlement" in the definition set out in Art. 2(1)(f) of the directive must be understood as covering any obligation giving a right to cash settlement and, therefore, also ordinary pecuniary debts owed by an account holder to his bank, such as the maintenance fee at issue in the main proceedings

   b) *The collateral-taker must be in 'possession' or 'control' of the collateral. If the collateral-provider can continue to dispose of the collateral, such shall not be validly provided within the terms of Directive 47/2002*. The court clarifies that, as mentioned in the directive, only a right of substitution or to withdraw excess financial collateral shall be regarded as not interrupting the continuity of control. It follows that the taker of collateral, such as that at issue in the main proceedings, in the form of monies deposited in an ordinary bank account, may be regarded as having acquired 'possession' or 'control' of the monies only if the collateral-provider is prevented from disposing of them. This condition that was not met in the case under consideration.

   c) *Directive 47/2002 does not cover collateral provided after the opening of the insolvency proceedings*.

4. This briefing note will only address questions 2 and 3, since regarding question 1 there is already enough Spanish case law affirming, almost without question, the expansive interpretation given by the CJEU..

5. Being "under the control of the collateral-taker" is an almost magical expression that appears three times in the body of the directive (recitals 9 and 10 and art. 2(2): "delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker"), which is provided as some "form of dispossession" of the collateral-provider [recital 10 and paragraph 40 of the judgment]. Though reproduced in Royal Decree Act 5/2005), in Spain these words have so far received no attention under case law and hardly any theoretical consideration (with notable exceptions, like the work of LYCZKOWSKA, *Garantías financieras*, 2013, pp. 121-252), as if it were a rhetorical *evidentia*, a redundancy or an emphasis without independent value. Not so in other jurisdictions, such as that of England and Wales, where 'control' was the cornerstone in determining whether floating charges on assets or money could be regarded as financial collateral. The CJEU's judgment in fact subordinates the confused wording of art. 1(5) ("forms a credit in a designated account") to the (not much clearer) art. 2(2) of the directive and raises a problem of scope in those European transpositions that have dispensed with the requirement of control or have sweetened it (such as that of Luxembourg or Germany).

6. Next, a distinction must be drawn between the three categories of assets on which financial collateral may rest. The problem does not arise (except with regard to 'securities deposit accounts') with "financial instruments", since the book entry in the 'relevant' account or the physical possession of the certificate acts as control. Neither does it arise with "credit claims" (i.e., receivables)

that only banks can pledge (art. 2(1)(o)), because it has been the undisputable decision of Directive 44/2009 (recital 6) that there should be no substantial requirements for European banks to be able to pledge collateral at the European Central Bank. There remains only financial collateral in the form of "cash", which strictly speaking is not money (that is why there can be no financial collateral in the form of banknotes [recital18]), but rather "credit to an account", that is to say, a special form of pledge of receivables against the depositary of the deposit account. Financial collateral is not under control simply because it has been identified, "provided" or "credited" (art. 1(5)), because control is a supplementary requirement under art. 2(2). However, the terminology is doubtful: it can also be said that, apart from the receivables, no collateral without transfer of control has been "provided" and this seems to be an implicit belief in the judgment, so that the lack of control would also drag along the "provision" of the collateral. Nor is the control satisfied with a "formal act" or with "notice" to the depositary debtor (art. 3(1)).

7. The CJEU's judgment adopts the 'negative' meaning of "control" as proposed by the English High Court decision in *Gray and others v G-T-P Group Ltd Re F2G Realisations Ltd (in liquidation) [2010]*. The creditor has control when he can legally and 'in practice' prevent the collateral-provider from transacting with the encumbered asset without the creditor's specific consent, unless the rights of the collateral-taker are limited to the exercise of the right of substitution and withdrawal of excess collateral within the meaning of arts. 9 and 10 of Royal Decree Act 5/2005. Therefore, positive "possession" or "co-possession" by the creditor that allows it, for instance, to also make use of the account, is insufficient. Nor is it sufficient for the depositary to be the same creditor (depositary bank), even if it may enforce against the collateral-provider an offsetting claim (there is no "automatic control" such as that under § 9-104(a) of the US Uniform Commercial Code). Neither is it sufficient to have signed a 'control agreement' with the depositary whereby the latter confirms that it possesses for and on behalf of the creditor and that it will obey its instructions if the debtor can ultimately dispose of the assets without the creditor's ad hoc consent. However, a 'control agreement' will be - though insufficient - necessary, unless the money is deposited with the creditor, in which case the problem of control disappears. A subrogation clause in the account ("money that comes in to cover the money that goes out") is not enough. In fact, it seems that not even consent to dispose granted in a generic, early, but freely revocable way, is sufficient.

8. The issue matters, since most of the pledges of accounts given in Spain, when they are 'project accounts', necessarily involve the debtor's entitlement to make use of the money in the account.

9. But why is control of the deposit account required, not sufficing notice (even acceptance) of the pledge by the depositary? It seems that the arguments contained in paragraphs 40 to 43 of the judgment do not correctly address the problem. It is not a question of "the safety of the parties" requiring financial collateral arrangements to "provide for some form of dispossession". Nor does it make sense to impose a requirement ("control") for the sole purpose of the collateral-taker to be able to 'effectively' dispose in the event of enforcement, because that problem lies with the collateral-taker, which, if the hypothesis stands, could thus give up control because it is the only party interested in such control. Neither does the requirement seem to meet the need for "rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects", as the judgment itself holds that financial collateral can secure monetary

obligations of any kind, even if compliance with the same has no systemic effect - most financial collateral provided in Spain had no systemic effect. In addition, note that for the exercise of the "enforcement" (outside insolvency proceedings) under art. 11 or 12(2) of Royal Decree Act 5/2005, specific control other than 'positive' control is neither presupposed nor needed.

10. It cannot be said that the favourable insolvency treatment under art. 15 of the Royal Decree Act (the rule is that insolvency proceedings do not affect pre-existing financial collateral) is justified by the fact that the creditor possesses or controls, since art. 59 *bis* of the Insolvency Act already shows us the little respect that this law has for immediate and exclusive possessions. Of course, the directive is not conditioned by the presuppositions of the Spanish legislator. It is not so much the possession of the taker as the non-possession of the provider that matters. The directive basis this - once the explanation of the 'systemic effect' has been discarded - on the fact that, if the debtor has no control over the assets (because it is under that of the creditor or some other on its behalf), the insolvency administrator cannot seek it through a contractual amendment that alters possessory rights. This is a reason. Another is as follows: whosoever wants to obtain insolvency advantages must assume the price of effective possession or control of collateral. In insolvency proceedings, there is no privilege without a price.

11. Let us now turn our attention to the third question in this judgment. The monies to which the collateral refers must have been credited to the account before the opening of insolvency proceedings. That is what the judgment states. That is to say, not only are collateral arrangements or collateral provided after the opening of insolvency proceedings excluded from the regime, but also the "provision" of money to an account already pledged beforehand (grounds 47 and 48 of the judgment). But what is the scope of this exclusion? Interestingly, I believe that none.

12. In order to enforce a pledge of cash deposited after the pledge has been given (outside the insolvency scenario), the creditor must also operate as provided in arts. 11 and 12 of the Royal Decree Act. That is, the creditor will take possession of the money by appropriation or set-off. This is true of any pledge of account receivables, whether financial collateral or not. Moreover, if the insolvency proceedings no longer produce the direct estoppel effect under art. 56 of the Insolvency Act, such will also be the method of enforcing the collateral, unless we argue that the monies credited to the account after the opening of the insolvency proceedings are not financial collateral, but actually assets available for distribution within such proceedings. But we can not state this in general. If the pledge of future assets meets the conditions of art. 90(1)(6) of the Insolvency Act, the pledge will be enforceable against the insolvency proceedings, and also the surrogates (money) of the pledged receivable. And this happens regardless of whether the pledge is financial collateral or not, because the former does not have any prevailing treatment in terms of future assets. In fact, art. 96(1)(6) of the same Act is the only thing that matters, regardless of the special nature or not of the pledge. Even the aforementioned art. 56 does not matter: as we are dealing with assets that are added to the assets available for distribution after the opening of insolvency proceedings and are already added encumbered, this article cannot operate, since this rule is limited to monies and cash encumbered before the opening of insolvency proceedings and the post-insolvency pledge agreement cannot be affected. Assets encumbered post-insolvency are not subject to stay periods in enforcements.

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