



Client Alert

Enforcement of Margin Loans in Light of Recent Case Law

The unprecedented market conditions of the last few months have triggered margin calls on a wide range of margin lending facilities. With rapidly falling prices of market traded assets, borrowers have increasingly been unable to meet prescribed security coverage ratios. Lenders, experiencing their own liquidity pressures, have been faced with difficult decisions between maintaining relationships with borrowers and managing their risk exposure by ensuring that the value of the collateral provided as security remains sufficient to repay their outstandings. The outcome of a recent case (the "**Fluxo Case**") on margin calls – *ED & F Man Commodity Advisers and Others v Fluxo-Cane Overseas Ltd and Others [2008] EWHC 1997 (Comm)* – will not make those decisions any easier.

Background

Margin lending describes various financing techniques backed by a portfolio of stocks, commodities, derivatives or any other form of market traded asset. A key feature of margin lending is that the borrower must maintain an agreed security coverage ratio at all times – that is, the mark-to-market value of the portfolio must be a multiple of the outstandings under the loan (depending on the volatility of the instruments). If the security coverage ratio drops below this level, this triggers a 'margin call', and the borrower will be under an obligation to either pay down the loan or 'top-up' the portfolio with additional assets to ensure that the coverage ratio is maintained. Failure by the borrower to maintain the coverage ratio will permit the lender to sell the portfolio of assets and apply the proceeds of sale to recover its outstandings. As margin calls are often made when the value of the underlying instruments is falling rapidly, the period for compliance can be very short.

The Fluxo Case

Fluxo-Cane Overseas Ltd. ("**Fluxo-Cane**") is a sugar trader that entered into margin lending arrangements with ED & F Man Commodity Advisers (the "**Brokers**") with respect to market traded sugar futures. As the value of Fluxo-Cane's sugar futures fell, its security coverage ratio fell below the prescribed level and, on 17 January 2008, the Brokers made a number of margin calls, requiring Fluxo-Cane to reduce its outstandings or 'top-up' with additional security.

In response to these margin calls, a meeting was held on 17 January 2008 (the "**First Meeting**") between Fluxo-Cane, the Brokers, and certain other clearing houses which had entered into margin lending arrangements with Fluxo-Cane. Those in attendance at the First Meeting discussed proposals to allow Fluxo-Cane time to meet the margin calls, as a prelude to an orderly reduction of Fluxo-Cane's open positions. The parties agreed to hold another meeting on 18 January 2008 (the "**Second Meeting**"), at which Fluxo-Cane was expected to provide a commitment to meet the margin calls, and reach an agreement with the Brokers and other clearing houses as to how to effect this reduction.

Prior to the Second Meeting, the Brokers began to enforce their security and liquidate Fluxo-Cane's positions. The Brokers subsequently brought a claim for summary judgment against Fluxo-Cane for unpaid margin payments and other sums due following the liquidation of Fluxo-Cane's positions. In its defence, Fluxo-Cane argued, amongst other things, that the liquidation of its positions was a breach of an oral agreement reached at the First Meeting. Fluxo-Cane also counterclaimed against the Brokers for losses incurred as a result of the liquidation of its positions.

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Judgment

Mr. Justice Walker held, based on a detailed analysis of the transcript of the First Meeting, and the accounts of those in attendance, that a binding oral agreement had been reached at the First Meeting that:

- there would be no liquidation of Fluxo-Cane's positions prior to the Second Meeting; and
- all participants would proceed on the express basis that if, at the Second Meeting, Fluxo-Cane could give a commitment to pay margin, the Brokers and other clearing houses would work together to achieve an orderly reduction of Fluxo-Cane's positions.

As this was an application for summary judgment, Walker J did not proceed to address any additional issues, such as whether Fluxo-Cane had a valid counterclaim against the Brokers for losses incurred as a result of the liquidation of its positions in breach of the oral agreement. In order to succeed in an application for summary judgment, the claimant must show that the defendant has no real prospect of defending the claim. The determination of the existence of a binding oral agreement not to liquidate was enough to show that Fluxo-Cane had a real prospect of being able to defend itself against the Brokers' claim at any subsequent trial.

Between a rock...

For a number of reasons – not least the desire to maintain relationships with valuable customers – lenders are likely to prefer to try to reach a consensual solution with distressed borrowers, and to manage defaults in an orderly manner. However, the Fluxo Case suggests that this approach is not without risk, and ideally, a preferred course of action should be decided before contact is made with a distressed borrower. In particular, this may require internal coordination between the legal, credit and relationship functions of an organization, in order to formulate an agreed strategy. This could be contrary to the instinct of relationship managers, who might instinctively reach out to their clients as soon as a potential default occurs to try to smooth the process – and only open discussions with legal and credit colleagues later.

Lenders will also need to be careful that, where appropriate, they co-ordinate with other lenders with separate exposures, and reach an agreed negotiating position prior to any meeting with the borrower. At the First Meeting, the Brokers and other clearing houses did not have an agreed position, and were forced to negotiate between themselves whilst engaging in a simultaneous dialogue with the borrower. As a result, the oral

agreement identified by the judge was found to have been reached between the Brokers and other clearing houses as a group, and the borrower. While the oral agreement in the Fluxo Case was relied on by the borrower as part of its defence, this leaves open the possibility of enforcement of such an agreement by other lenders – and it is conceivable that a judge may be more sympathetic to the claims of a dissenting lender than a defaulting borrower.

... and a hard place

The Fluxo Case may represent a 'softening' of the attitude of the English courts to the strict enforcement of lender rights. In *Cripps Pharmaceuticals Ltd v Wickenden* [1973] 2 All ER 606, an English court confirmed that, whilst a lender must give a reasonable period of time for a borrower to pay before enforcing an 'on demand' loan, the reasonableness requirement may be satisfied by as little as two hours notice on a banking day (at least in circumstances where the borrower is clearly unable to pay)! Cases like *Cripps* seem harsh by modern standards, and it seems possible that English judges may proactively find ways to mitigate their harshness.

In this respect, English law has for some time been considered far more lender friendly than many other jurisdictions. For example, the US Uniform Commercial Code imposes an express requirement of good faith on the part of a lender accelerating a loan. Jurisdictions whose legal systems have their roots in the Napoleonic Code (France, Belgium, Netherlands, and many of their former colonies) go even further, with a wide concept of good faith that requires a lender to take into account the effort a borrower would need to expend in order to comply, as well as any unforeseen changes in circumstances, in deciding how much time should be given to a borrower to remedy a breach.

Judges in such jurisdictions are typically afforded a large degree of discretion in interpreting this principle, and have held that borrowers must be given quite lengthy periods of time (up to two months in some European cases) to make arrangements to pay. Note that the principle of good faith in contractual dealings is a mandatory principle of private law which may not be waived by contract – it is therefore possible that a court will apply this principle notwithstanding a clear choice of law clause in the underlying agreement. The principle of good faith can have a real sting in its tail in jurisdictions where the judicial process is less than transparent, and counter-suits against lenders are not uncommon. Consequently, an approach that amounts to 'enforce first, ask questions later' may also not be without its risks.

Practical Conclusions

Lenders, encountering a considerable increase in borrower defaults given the current economic situation, may be faced with a difficult dilemma, between entering into discussions with the borrower and risking being deemed to have entered into a compromise, and simply going ahead and enforcing, risking liability for unreasonable conduct. This dilemma will be particularly acute for lenders managing defaults under margin lending facilities, who may be required to act quickly in view of a rapid devaluation of the portfolio of market traded assets provided as collateral.

The correct negotiation and enforcement strategies will vary on a case by case basis. However, ensuring effective internal communication between credit, relationship and legal teams both prior to, and during, a default situation will invariably be necessary in order to ensure that lenders adopt an efficient and consistent approach in dealing with a distressed borrower. In addition, lenders should obtain advice from local counsel in the appropriate jurisdiction(s) (typically the jurisdiction(s) of the borrower and in which the secured assets are located,

especially if this is also the governing law of the security documents) at an early stage, to ensure that:

- all negotiations with the borrower are carried out on a non-binding, 'without prejudice' basis, so as not to compromise the lender's rights of recourse; and
- that the lender satisfies any local law requirements to act reasonably or in good faith towards the borrower prior to any acceleration or enforcement of the loan.

Lender enforcement proceedings have become an unfortunate fact of life given current market conditions. The Fluxo Case comes as a timely reminder that such enforcement proceedings are not without their risks for lenders, particularly in unusual market circumstances, where courts may be willing to give borrowers a little more breathing space. In cases that have complex facts or involve debtor-friendly jurisdictions, steering the right course can be a challenging task.

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