Feature

KEY POINTS

- Mr Tchenguiz apparently provided shares *in* Kaupthing as collateral for loans from Kaupthing.
- Section 658(1) of the Companies Act 2006 provides that, subject to certain specified exceptions, a limited company must not acquire its own shares. The word 'acquire' would seem to refer to a company becoming the owner of its own shares.
- Not all forms of security over shares give the collateral taker an immediate proprietary right in the asset but possible transfers in voting rights etc may cause transparency problems.

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Aluminium, fish and some unusual collateral: the pitfalls of lending on the security of your own shares

The story of the collapse of the Icelandic banking system in 2008 is an often told if not well loved tale. Yet, for all its familiarity, many of the facts of the largest systemic collapse in financial history remain extraordinary.

THE COLLAPSE OF ICELAND'S BANKING SYSTEM

Iceland's ascent to the scaffold began early in the new millennium when aluminium mining and the accumulated prosperity of the fishing industry meant that its economy was awash with cash. Much of this cash came to be invested in equities and following bank deregulation in 2001 three banks in particular: Glitnir Bank hf., Kaupthing Bank hf. and Landsbanki Íslands hf, were in the vanguard of the familiar housing and stock market boom which followed. A favourable credit rating and its membership of the European Economic Area gave Iceland ready access to European capital markets and in 2005, for example, the aggregate value of debt securities issued by these banks in the European capital markets (some €14bn) exceeded Iceland's then GDP. Significant forays into the US capital markets followed, this time by the repackaging of debt as Collateralised Debt Obligations.

All good things must come to an end and when the domestic boom faltered the credit ratings of Iceland's banks were downgraded by the international agencies. Instead of chastened retrenchment, these banks realigned their international activities by seeking to attract foreign retail investors which, notoriously, included the provision of online high interest deposit accounts to foreign depositors. In the UK (and the Netherlands) this was through Landsbanki's 'Icesave' and, in various European countries, Kaupthing's 'Edge'.

This overseas expansion took place against a background of a seriously dysfunctional economy: a current account deficit which ranged from 15-25 per cent over the course of 2006-7, inflation of some 14 per cent in 2008 and interest rates which at their pre-crisis peak reached 15.5 per cent (in the throes of the crisis which followed they reached 18 per cent). It was of course these high interest rates which created the conditions for the high rate deposit account phenomenon and for its currency, the ISK, to trade at a value which the actual state of the economy could not remotely justify.

Even before the collapse of Lehmann Brothers in September 2008 pulled the rug on anyone needing to finance short-term debt, questions were being asked about the extent to which Iceland had any reliable deposit guarantee scheme. The financial convulsions of September exposed the fact that, at least by then, the Central Bank of Iceland did not have the resources to underwrite the debts of Icelandic banks and no international institution was prepared to assist. At the end of September, Iceland's government attempted a partial nationalising of Glitnir but receivership – at the behest of the Financial Supervisory Authority – intervened and after a run on Icesave, Landsbanki also entered receivership on 7 October. The Icelandic government refused to offer to bail out its investors and the UK government decided that it would come to the aid of UK investors (to the eventual tune of some £2.5bn), even though the UK's deposit protection guarantee did not apply to Icesave since it was a UK branch rather than subsidiary of Landsbanki. The UK also invoked legislation designed for terrorists and rogue states (ss 4 and 14 and Sch 3 of the Anti-terrorism, Crime and Security Act 2001), to freeze the UK assets of Landsbanki; it thereby found itself in the unfamiliar and less than congenial company of North Korea, Burma and al-Qaeda – the damage to Anglo-Icelandic relations has not yet been repaired. The Financial Services Authority ('FSA') then put Kaupthing's UK arm (Kaupthing Singer & Friedlander) into administration and sold Kaupthing Edge to ING; Kaupthing in Iceland entered receivership on 9 October. The combined debt of these three banks amounted to several times Iceland's GDP.

Resort to the International Monetary Fund was unavoidable and its consequence was that a country with a population of only 320,000 was forced to borrow some $4.2bn, equivalent to more than $13,000 per head. Various other loans and currency swaps with other countries are reputed to have taken the value of (and liability under) the whole rescue package to about $10bn.

ICELAND'S 'TRUTH' COMMISSION

The government fell, as did the head of the central bank, and in December 2008 the Icelandic parliament, the Althingi, appointed a Special Investigation Commission ('SIC') to investigate the causes of the collapse. The SIC presented its report to the Icelandic parliament in April 2010 and its conclusions are appropriately damning of both political

and regulatory control and the management of the banks.

When it came to lending practices, the Commission identified that the main owners of the largest banks were also its largest debtors (that is as borrowers rather than contributories) and that these owners had 'abnormally easy access' to such loans. Of Kaupthing it said that its largest shareholder, Exista hf, was also its second largest debtor and that its largest debtor was Robert Tchenguiz, a shareholder and board member of Exista. The Commission also identified:

- that to a very significant extent loans by the banks financed purchases of their own shares (including it seems a 5 per cent share in Kaupthing acquired by the state of Qatar);
- that the banks had themselves purchased their own shares in the market by way of automatically matched trades and had also entered into forward contracts in relation to their own shares; and
- that the banks accepted their own shares as collateral for some of the loans which they made (including loans for the purpose of buying those shares).

THE TCHENGUIZ CONNECTION

The first and third of these features was brought into sharp relief by the arrest (and subsequent release without charge) of Robert and Vincent Tchenguiz by the Serious Fraud Office in March 2011. These (and other arrests) and the associated seizure of large quantities of documentation were carried out in conjunction with Icelandic prosecutors.

The Tchenguiz brothers are well known businessmen with a reputation for adventure. In the context of Iceland and its banks, the Commission recorded that Robert Tchenguiz appears to have owned at least 1.5 per cent of Kaupthing Bank's shares and also to have been a director of and investor in Exista. By the time of Kaupthing's demise, he had been provided with loan facilities of:

- €2bn (£1.7bn) from Kaupthing hf;
- €210m (£180m) from Kaupthing Bank Luxembourg; and
- €95m (£82m) from Kaupthing Singer & Friedlander in the UK.

There had been large increases in Kaupthing's lending to him in the period from January 2007 until October 2008 when many of Mr Tchenguiz's business interests were in decline. Like so much pre-credit crisis finance, the Tchenguiz business model was highly leveraged and, therefore, indebted to other banks too. Kaupthing's records revealed that its loans to him were often used to meet margin calls from these other banks and there appears to have been the yet further complication that Kaupthing had taken stakes in some of Mr Tchenguiz's business ventures.

Conventionally, a bank becomes less willing to lend as its debtor's fortunes decline but its willingness and ability to take this approach obviously depend upon the bank's exposure to that particular debtor and in particular what proportion of its loan book that debtor represents and the nature and quality of any security given against counterparty default. This must, in part, explain why Kaupthing took such a contrary approach; its fortunes having become too closely tied to the fortunes of Mr Tchenguiz – to adopt a now well-worn phrase, for Kaupthing he had become too big to fail.

When it comes to security, Mr Tchenguiz had apparently provided shares *in* Kaupthing as collateral; this was (or should have been) a further source of discomfort for the bank. As collateral, listed securities do at least offer liquidity but are an inherently volatile and therefore rather unreliable form of security. Even in the ordinary case where shares in *other* companies are offered as collateral, difficult questions of what margin to require and what haircut to apply arise and much will, of course, depend on the duration of the facilities which they secure and, crucially, the nature of the company in question.

When the shares are *your* shares then you have a special interest in what happens to them and, for example, whether any default sale of them will depress their and your market value (and capital base). Where other borrowers have also provided your shares as collateral for loans then default by one such borrower therefore has the potential to reduce the value of such security for the other loans which have not (yet) defaulted. In those circumstances transactions such as the purchase of their own shares could be said to have amounted to 'share support' as risk mitigation, to the extent – which the SIC report throws into doubt – that any meaningful risk management, rather than merely cosmetic adjustment, was really being undertaken by these banks.

THE LEGAL PERSPECTIVE

There are legal issues too – at least under English and EU law – at both a market/regulatory and private law level although neither the available information nor space permits more than a suggestion of the legal principles which might be engaged by the unusual practices of the big Icelandic banks. The musings which follow proceed on the understanding that Iceland is not subject to EU law and that the scope for the application of English law to the loans to Robert Tchenguiz may have been modest at best.

Market abuse/transparency

At a market and regulatory level, the Market Abuse Directive (2003/6/EC) seeks to promote market integrity by the prevention of market abuse. Section 118(8) of the Financial Services and Markets Act 2000 ('FSMA') provides as to behaviour which constitutes market abuse that it includes behaviour which:

- is likely to give a regular user of the market a false or misleading impression as to the supply of, demand for or price or value of, qualifying investments; or
- would be, or would be likely to be, regarded by a regular user of the market as behaviour that would distort, or would be likely to distort, the market in such an investment; and
- the behaviour is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.

There are also the provisions of the Transparency Obligations Directive (2004/109/EC) to which Pt 43 of the Companies Act 2006, Pt 6 of the FSMA and the Disclosure and Transparency

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Rules in the FSA Handbook give effect. The purpose of these rules is to ensure the ongoing supply of information relevant to an informed decision by a prospective investor whether to invest in the particular company's securities. The categories of information to which they apply include interim financial reports (containing an explanation of material events and transactions that have taken place during the relevant period and their impact on the financial position of the company together with a general description of the financial position and performance of the company during the same period), 'vote holder information' (see below for likely security techniques and the transfer of voting rights which they may involve), 'information relating to the rights attached to the shares or other securities' and information about new loan issues and any connected guarantee or security.

English company law and the security technique

The law applicable to each loan facility is unclear but presumably the Euro facility provided to Mr Tchenguiz by Kaupthing Singer & Friedlander in the UK was governed by English law. What security technique was used in relation to Mr Tchenguiz's shares in Kaupthing is unknown but the possibility that Kaupthing might, on default by Mr Tchenguiz, acquire its own shares raises questions as to the lawfulness of such a transaction/possibility.

This is because s 658(1) of the Companies Act 2006 provides that, subject to certain specified exceptions, a limited company must not acquire its own shares, whether by purchase, subscription or otherwise and that where a company purports to act in contravention of this prohibition the purported acquisition is void and an offence is committed by the company and every officer of the company who is in default. These exceptions include the acquisition of shares otherwise than for valuable consideration *viz* gift, bequest etc, forfeiture (or surrender) but only for failure to pay any sum payable in respect of those shares and pursuant to the order of the court in a number of specific but non-applicable circumstances. Given that the s 658 prohibition is directed at the maintenance of capital the word 'acquire' would seem to refer to a company becoming the owner of its own shares.

Pledges and charges

A pledge requires there to be property the possession of which can be transferred and thus a pledge, in the strict sense, over shares would therefore require them to be bearer shares – negotiable instruments in respect of which possession would amount to entitlement – and which are nowadays uncommon. Such a pledge would give the secured party a right to possession but not ownership of the shares in question.

It is commonly said that a pledge gives the secured party a special property in the asset in question (as in *Matthew v TM Sutton Ltd* [1994] 4 All ER 793) but this probably does not amount to a (present) proprietary right in the asset. If the borrower defaults then the pledgee's remedy is usually to apply to the court for an order for sale and then the pledgee does not do so as owner and his right to the proceeds will usually be limited to the extent of the borrower's indebtedness. Whether this is so depends on the nature of the pledge agreement; if this provides for the pledgee's entitlement to absolute title to the asset on the default of the debtor then the case is rather different and it could be said that acquisition of the shares, in the prohibited sense, would therefore occur, if, which is not unarguable in the case of bearer shares, it did not happen on the initial taking of possession.

In the case of mere share certificates of registered shares, any pledge is likely to amount to an equitable mortgage – or possibly a pledge only of the certificates – with the effect that the pledgee would have a right of sale (or foreclosure) but once again by order of the court (see *Harrold v Plenty* [1901] 2 Ch 314). This is because possession of such a certificate does not give the pledgee title to the share as against the company and this is so even if, as is usual, the certificates are accompanied by an executed form of transfer of the shares. This is a very common form of security and is only registrable under the Companies Act 2006 where future dividends are also charged *and* such dividends are the borrower's book debts. By foreclosure the lender would of course become the owner of its own shares.

Similarly, a charge:

> '... is a security whereby real or personal property is appropriated for the discharge of a debt or other obligation, but which does not pass either an absolute or a special property in the subject of the security to the creditor, nor any right to possession. In the event of non-payment of the debt, the creditor's right of realisation is by judicial process.' (See Fisher & Lightwood's Law of Mortgages.)

Whether the intervention of the court is in fact required depends on the terms of the charge.

Shares are now commonly 'dematerialised' and there is therefore no certificate. If these are directly held by the borrower then giving them as security would involve transferring them into the name of the lender if it is a member of, eg CREST or to a nominee which is such a member but in either case the substance of such a transaction is one of legal mortgage. The CREST register does not recognise that the person in whose name the shares are registered is only a mortgagee and if one adopts what Slade J said in *Re Bond Worth Ltd* [1980] Ch 228 at 250 *viz* that:

> '[t]he technical difference between a "mortgage" or "charge", though in practice the phrases are often used interchangeably, is that a mortgage involves a conveyance of property subject to a right of redemption, whereas a charge conveys nothing and merely gives the chargee certain rights over the property as security for the loan': see Megarry and Wade, *The Law of Real Property*, 4th ed. (1975), p 887.

then this technique of taking security over shares sails uncomfortably close, at its very outset rather than potential end result, to acquisition. It is certainly an argument that one would rather avoid having. ■