

# Implications of margin lender insolvency



## FEATURE ARTICLE

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## Introduction

The past year has seen a dramatic tightening of global credit markets amid rising concerns about the valuation of corporate debt instruments and the secured assets and credit ratings underpinning the various instruments. In Australia, the resulting market volatility has played havoc with investors, who have witnessed dramatic falls in the Australian Stock Exchange (ASX). Concerns about share valuations have driven up market trading volumes and put pressure on many companies, who have seen up to 30 or even 40 percent of their shares changing hands in a single trading day. The trading volatility has also put securities firms under significant strain, as demonstrated by a string of collapses of companies offering margin lending arrangements, including Lift Capital, Primebroker Securities (a division of Chimaera Financial Group) and of course, Opes Prime.

*These collapses raise many important insolvency issues, particularly the rights of investors under margin and other securities lending arrangements when the lender becomes insolvent.*

The pre-2007 boom in equity markets attracted many investors into leveraged share purchases through the use of margin lending services. Thousands of these investors have now been left in a difficult position as their shares held on margin have been sold out when the lending firms have gone into voluntary administration and/or receivership. These collapses raise many important insolvency issues, particularly the rights of investors under margin and other securities lending arrangements when the lender becomes insolvent. This article will consider these issues and discuss the recent Opes Prime test case concerning the interpretation of margin lending arrangements used by Opes Prime.

## The collapse of Opes Prime

The Opes Prime group of companies was established in 2003 by a number of staff involved in the establishment of Tricom (another stock broking firm in the news after failing to complete several trades in early 2008). Opes Prime was involved in stock broking, asset management, Islamic finance and financial services. Margin lending played a major role in Opes Prime's operations, and it received hundreds of millions of dollars in funding to build its margin lending business from the Australian and New Zealand Banking Group (ANZ) and Merrill Lynch, both of which were

granted security over shares held on margin by Opes Prime companies shortly before the broker's collapse. What made Opes Prime so attractive to investors was its willingness to enter margin lending arrangements over shares in small to medium companies listed on the ASX. Most major banks and securities firms limited their margin lending books to shares in the largest and most liquid companies on the ASX.

The dramatic increases in trading volumes in early 2008 and falling share prices put significant pressure on loan-to-value ratios of many of Opes Prime's clients. The firm's problems were exacerbated by an apparent failure to make margin calls on key clients, and allowing key clients to take up substantial segments of their margin lending book (particularly with very large positions in volatile stocks such as Challenger Financial Services, which in March 2008 had its share price halved). This left the firm vulnerable to the market volatility that has been so widespread in the last 18 months. Opes Prime lost the confidence of its financial backers who called in Deloitte as receivers on 27 March 2008 and the directors placed the firm into voluntary administration on 27 March 2008 with Ferrier Hodgson being appointed as administrators. The firm's financiers sold out hundreds of millions of dollars worth of shares held under the margin lending arrangements between Opes Prime and over 1200 of its clients. The shares covered over 600 companies listed on the ASX valued in total at more than \$1 billion.

Dozens of clients have commenced proceedings in relation to the collapse of Opes Prime which has resulted in several class actions and many individual court cases. One important issue has been whether Opes Prime engaged in misleading or deceptive conduct in its communications with clients regarding the nature of the securities lending agreements, which is yet to be determined by the courts. Another important issue in some of these cases was whether the clients retained an equitable interest in the shares still controlled by the receivers and could therefore attempt to stop the receivers selling the shares to repay the secured loans. This issue was decided upon in the Opes Prime test case: *Beconwood Securities Pty Ltd v ANZ Banking Group* (2008) 66 ACSR 116; [2008] FCA 594.

## The Beaconwood Securities case

On 2 May 2008, Justice Finkelstein decided a test case (*Beaconwood*) on the rights of investors in Opes Prime's securities lending arrangements. This case was concerned with interpreting the legal effect of the securities lending documents regarding the status of investor claims over parcels of shares held in a range of small to medium sized companies listed on the ASX.

The plaintiffs, Beaconwood Securities Pty Ltd and Beaconwood Ltd (hereafter **Beaconwood**) took out loans from Opes Prime for approximately \$1.3 million. In order to obtain the loan Beaconwood transferred a total of approximately 13 million shares (worth approximately \$7 million) it held in three separate companies to a subsidiary of Opes Prime. These shares were then transferred by the Opes Prime subsidiary to a subsidiary of ANZ, which provided substantial funding to Opes Prime to operate its margin lending services. The loan funds provided by ANZ to Opes Prime were subject to security held by ANZ over the shares held by Opes Prime and its subsidiaries. When Opes Prime collapsed, ANZ appointed a receiver to protect its interests in the remaining assets and then proceeded to sell-on market shares that Opes had transferred to it pursuant to its funding agreement with ANZ. This resulted in losses for hundreds of Opes Prime clients who had transferred their shares to Opes Prime after taking out margin loans to leverage their portfolios.

The securities lending documents provided that '*all right, title and interest in [any Securities, Equivalent Securities, Collateral or Equivalent Collateral] will pass absolutely from one Party to the other, free from all liens, charges, equities and encumbrances, on delivery or redelivery of the same in accordance with this Agreement*'. If and when the loan funds were repaid by Beaconwood, it was entitled under the contract to receive '*equivalent securities*' to those which it had transferred to the Opes Prime subsidiary. This allowed Opes Prime to deal with the transferred shares as it saw fit, and lending or selling the shares to third parties, including parties that wished to cover short sales. Opes Prime also drew fees from maintaining the securities lending facility. Beaconwood was thus trading its legal title over the shares in exchange for the use of loan funds and a contractual right to equivalent shares if it repaid the loan funds.

During the period of the securities lending arrangement Opes Prime's subsidiary would be bound to pay to Beaconwood any dividends or other benefits it would accrue if it continued to hold the shares transferred under the arrangement. As noted by the court, this was an attempt to '*manufacture*' for Beaconwood a contractual equivalent to the beneficial interest it would have retained had it not transferred its shares under the securities lending arrangement.

Beaconwood argued that ANZ was not entitled to sell the shares transferred to Opes Prime's subsidiary under the securities lending agreement because the arrangement created either a mortgage or a charge over the shares. The court rejected both arguments on the basis that the securities lending arrangement demonstrated a clear intention on behalf of both parties to fully transfer title and beneficial ownership of the shares from Beaconwood to Opes Prime.

In rejecting the mortgage argument, Finkelstein J relied upon the following elements of the securities lending arrangement (at [50]):

- Absolute title in the shares was transferred.
- There was no obligation to return the shares *in specie* if and when the loan funds were repaid
- There were set-off and netting arrangements in place for an event of insolvency, which demonstrated that the parties did not intend to retain an equitable interest over the shares, as such a conversion of a redelivery obligation into a payment obligation would be a clog on the equity of redemption.

The contention by Beaconwood that it had '*intended*' the agreement to act '*like a mortgage*' did not convert the clear wording of the agreement from an outright transfer into a mortgage (at [51]-[53]). The failure of the mortgage argument may be contrasted with another decision involving another '*securities lending agreement*' in *Re Lift Capital Partners Pty Ltd (Admins Apptd)* [2008] NSWSC 446. In that case the document referred to the securities lending as a mortgage, however the document also provided that Lift Capital could '*hedge*' its exposure by transferring the securities at any time without notice, which the court noted may be impermissible as a clog on the equity of redemption (at [13] per Austin J).

Finkelstein J also rejected Beaconwood's argument that the securities lending arrangement constituted a charge on the basis that Opes Prime was permitted to deal with the lent securities as it saw fit. Whilst it had an obligation to return '*Equivalent Securities*' if and when the loan was repaid, this obligation did not have to be met from the shares actually lent by Beaconwood. Opes was at liberty to provide the equivalent securities from its own holdings or in the open market. Thus, any shares that could come within the concept of equivalent securities only became that when they were appropriated to the contract and delivered to Beaconwood. As Finkelstein J held '*until property which is previously unidentified is appropriated to an agreement, neither a legal nor an equitable interest in that property can be created by that agreement*' (at [57]).

Beconwood could not therefore establish an equitable interest over the shares held by ANZ and was unable to prevent ANZ selling the shares to repay its loan to Opes Prime.

The Opes Prime test case covers a narrow, though important issue in the ongoing battle between ANZ and former margin lending clients of Opes Prime. Justice Finkelstein specifically did not consider the potential legal impact of any proof that conduct by Opes Prime or ANZ was misleading or deceptive or constituted some other misrepresentation or unconscionable conduct. However, the case does emphasise that the legal effect of the contract, however it may be named (margin lending arrangement, securities lending agreement etc), will not be determined by the subjective intentions of the parties. The precise wording of the agreement is paramount, and firms must ensure that standard form documents and widely used precedents are utilised in a manner that suits the particular wishes of the parties.

## Subsequent developments

The Beconwood case is only one of a number of cases pending in respect of disputes by former Opes Prime clients and the treatment of the client's former shares by ANZ and its receivers. In *CMG Equity Investments Pty Ltd v Australia and New Zealand Banking Group Ltd* (2008) 65 ACSR 650;

[2008] FCA 455, Finkelstein J found that shares under its securities lending agreement which had been transferred by Opes Prime to ANZ could not give rise to an injunction to restrain ANZ from selling the shares. This was because third party rights (i.e. the transfer to ANZ) had intervened to remove any equitable interest that CMG may have had in the shares as a result of the alleged misleading statements made by Opes Prime about the nature of the securities lending arrangements.

Whilst obviously each case turns on its facts, all hope is not lost for the Opes Prime clients. In a subsequent case, *Phisci Pty Ltd v Green Frog Nominees Pty Ltd* [2008] FCA 638, Finkelstein J granted an injunction against Green Frog (the Opes Prime subsidiary involved in the Beconwood case) from dealing with shares registered in its name pursuant to a securities lending agreement with Phisci. However, what distinguishes this case from Beconwood is that first, the shares were held by Green Frog and had not been transferred to a third party. Second, this involved an interlocutory injunction pending the final trial of the issue as to whether Phisci had any interest in the shares. The assessment of whether an injunction could be ordered depended upon whether Phisci would suffer irreparable harm and whether it had an arguable case that it was misled into the nature of the arrangement. The court found both elements were satisfied as Phisci would have its proposed takeover

of a New Zealand company (using shares acquired on its behalf by Green Frog under the securities lending agreement) frustrated. Phisci was however required to pay money into court as potential compensation to Green Frog if at trial its case was dismissed (which is common for injunctions granted prior to going to trial). This finding may be compared with the earlier decision in *Melewar Steel Ventures Ltd v ANZ Nominees Ltd* [2008] NSWSC 345, where the court refused to grant an injunction pending trial on the basis that a damages award (if the trial court confirmed the plaintiff's case) would be a sufficient remedy for the sold shares.

The Opes Prime collapse has already generated extensive litigation and will continue to do so. This benefits no one, particularly not the administrators and receivers who are forced to engage in costly and time consuming litigation that delays the efficient process of the company's administration. This has been recognised by the administrators and the banks (although not affected clients) who have been reported to be engaged in settlement negotiations.

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The Beconwood case would seem to go some way to stemming the tide of claims of equitable interests, however the Phisci case proves that the differing circumstances of each Opes Prime client may result in equitable rights that at least allow an injunction to stop further share sales. However it is arguable

that the Phisci case will be limited to its facts and clients whose shares were transferred to third parties such as ANZ and Merrill Lynch will have a difficult battle stopping further sales on the basis of claims of misleading or deceptive conduct. The litigation still has further to run as the administrators have applied to the Federal Court to give directions on the appropriate date for calculating a just estimate of the contingent claims by the client creditors. The administrators have sought to apply the provisions of the *Payment Systems and Netting Act 1998* (Cth) to the claims by client creditors, which has the potential to substantially alter the value of their claims in the administration.

The Opes Prime debacle provides a useful illustration of the collective problem raised by insolvency and the need for a centralised, co-ordinated process for administering the insolvent estate, particularly the problems caused by multiple creditors seeking to enforce their rights individually. Collective losses from the Opes Prime collapse would no doubt have been much greater if the company had not entered external administration. The investor confusion and frustration at their inability to retrieve their (former) shareholdings also demonstrates the importance of understanding a document before you sign it and the dangers inherent in retail investors entering financial markets, traditionally dominated by wholesale participants. 