Financial Services

Conflicts of law and collateral in international securities markets

by Dr Joanna Benjamin

Dr Joanna Benjamin

The collateralisation of financial exposures reduces credit risk and may achieve capital weighting efficiencies. Market securities are a favoured form of collateral, being liquid and easy to value. For these reasons the role of securities as collateral for international financial exposures is vast and certain to increase.

Lawyers acting for those taking securities collateral are regularly asked to give legal opinions on the collateral arrangements; in view of the large sums involved, the desire to achieve legal clarity is intense. Part of the legal analysis involves conflict of laws questions which arise where the collateral giver and/or the collateral securities are located in another jurisdiction. This paper considers English private international law as it relates to the use of securities in cross-border collateral arrangements.

A wide range of legal techniques are used to take collateral. They fall broadly into two categories. The first comprises security interests, such as a mortgage or a charge, whereby the collateral giver retains a property right in the collateral, known as the equity of redemption; this is the right to the return of the collateral upon the discharge of the secured obligation. Upon the default of the collateral giver, the collateral taker may generally enforce its security interest by selling the collateral securities. The second category of collateral technique involves transferring the collateral securities outright to the collateral taker. The collateral giver only has a personal (i.e. contractual) right to the return of securities equivalent to those it put up as collateral. Upon the default of the collateral giver, the collateral taker generally sets off its contractual obligation to return equivalent collateral securities against the secured obligation.

The creation of both forms of collateral arrangement involves two stages:

(1) the formation of a contract;

(2) the delivery of a proprietary interest in the securities pursuant to that contract (whether a security interest or outright transfer).

The first involves personal rights and the latter property rights.

CONFLICT OF LAWS FOR SECURITY INTERESTS

Broadly speaking, where a security interest is involved, the two stages referred to above involve a consideration of six separate steps:

(1) the formation of a valid contract;

(2) attachment to the collateral assets;

(3) perfection of the security interest;

(4) the priority of the security interest;

(5) the enforcement of the security interest;

(6) the displacement of the security interest.

The parties must ensure that the collateral contract is materially valid, i.e. that nothing in its nature invalidates it (such as want of consideration, or running contrary to public policy). Also, it must be shown that the collateral giver has power to enter into the contract (under its constitution and by local law). Further it must be established that the individual executing the agreement has authority to bind the corporate counterparty. Any formal requirements (such as notarisation) must also be considered.

Under English private international law material validity is generally determined by the governing law of the agreement. Power and capacity issues will generally be determined by the law of incorporation (*Carl Zeiss Stiftung v Rayner (No. 2)* [1967] 1 AC 853 at 972E and 919G). A contract is formally valid if it complies with the formal requirements of its governing law or the law where either party is located (art. 9 of the Rome Convention, implemented by the *Contracts (Applicable Law) Act* 1990).

A valid contract confers personal rights. The next stage is to confer property rights in the collateral by attachment of the security interest. This protects the collateral taker in the insolvency of the collateral giver. Under English private international law attachment should satisfy the requirements of the law that governs property interests in the collateral securities. The general rule is that property interests in assets are governed by the lex situs of the assets, or the law of the place where they are legally located. In the case of tangible assets (such as bearer bonds in their traditional form) this will be their physical location. In the case of intangible assets such as shares, the general rule is that situs is determined by the practicalities of enforcing the property interest, so that shares are legally located where the relevant register or branch register is located, as discussed more fully below. The attribution of a location to an intangible of course involves a legal fiction, and some have argued that it is artificial to apply the lex situs rule to intangibles (although the court of appeal decision in *Macmillan v Bishopsgate Investment Trust plc (No 3)* 1995 All ER 747 supports such application). A simpler approach might be to refer questions of property in relation to intangibles to the jurisdiction where enforcement must take place, not because that is the situs of the asset, but because the practicalities of enforcement require it. For ease of reference, this article will continue to refer to the lex situs rule.

Perfection

In effect perfection involves giving notice to the world at large of the security interest so as to make it binding on third parties. Generally perfection is governed by lex situs; additional requirements may be imposed by the law of incorporation of the collateral giver: see, for example, the registration requirements of the UK *Companies Act* 1985.

Priorities become relevant where the collateral securities are subject to other competing security interests which have also been perfected. Where successive security interests are created, priorities are generally determined by the law governing the securities, i.e. French law for French law securities. An alternative argument is that priorities are governed by the law of the forum, i.e. English law in the English courts. (See *Le Feuvre v Sullivan* (1855) 10 Moo PC 1 at 13; *Kelly v Selwyn* [1905] 2 Ch 117 at 122 and *Republica de Guatemala v Nunez* [1925] 1 KB 669 CA.) However when the challenge to the collateral taker comes from a tracing claim (as in the Maxwell scandal) priorities are determined by lex situs (*Macmillan v Bishopsgate Investment Trust plc* [1996] 1 WLR 387).

It is also essential to ensure that collateral can be readily liquidated without undue delay and formalities. For example, it is necessary to confirm that the law of the jurisdiction where the securities are held does not require the involvement of the court in the sale of securities and that local exchange controls do not restrict the remittance of the proceeds of sale.

Security interest

A risk for collateral takers is that its security interest may be displaced where the collateral giver was affected by fraud or insolvency, under a tracing claim or under 'hardening rules' whereby an insolvency official can unscramble certain transactions which prejudice general creditors. As part of insolvency law, hardening rules are generally applied on a mandatory basis. Therefore it is essential to check the position under the law which would govern the insolvency of the collateral giver. In many cases this will be the law of incorporation; however the jurisdiction of a branch may assume insolvency jurisdiction. (For UK branches of foreign companies, see s. 221(5) of the *Insolvency Act* 1986.) As indicated above, as a matter of English law, tracing claims are governed by lex situs.

Therefore security interests should always be considered under lex situs, i.e. France for bearer bonds held in France, and also under the insolvency jurisdiction of the collateral giver in addition to the governing law of the collateral contract.

PROPERTY RIGHTS

A valid contract confers personal rights. The next stage is to confer property rights in the collateral by attachment of the security interest. This protects the collateral taker in the insolvency of the collateral giver. Under English private international law, attachment should satisfy the requirements of the law that governs interests in the collateral securities.

CONFLICT OF LAWS FOR OUTRIGHT TRANSFERS

In relation to outright transfers of collateral, different concerns arise. Of course the contractual concern of material and formal validity, capacity and authority are also relevant, as well as displacement of the contract through tracing or insolvency hardening rules. However there is no need to consider attachment, perfection and priorities. Instead the key concerns are delivery, set-off and recharacterisation.

Delivery

First the collateral taker must ensure that it acquires full unencumbered title to the collateral securities; this will generally take place through a settlement system, global custodian or other settlement agent. Lex situs will determine whether there is good delivery.

Set-off

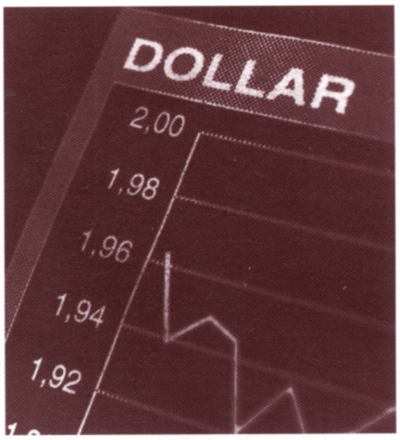
Secondly it must ensure that its rights to set off its contractual redelivery obligations against the secured obligation will be recognised in the insolvency of the collateral giver. Certain jurisdictions are reluctant to recognise insolvency set-off, as being unfair to general creditors. The risk is that the collateral taker may be obliged to redeliver the collateral, and then prove as an unsecured creditor for the secured obligation. Clearly reference must be made to the insolvency jurisdiction of the collateral giver. (Because of this rule, and to reflect regulatory capital requirements (see Securities and Futures Authority rule 10–173), standard opinions in a large number of jurisdictions have been obtained by [International Swaps and Deriratives Association, Public Securities Association/International Securities Market Association] and the Stock Lending and Repo Committee of the Bank of England in relation to market standard documentation.)

Recharacterisation

Thirdly it must consider recharacterisation risk. This is the risk that, on the default of the collateral giver, the courts would recharacterise the collateral arrangements as creating a security interest. One of the chief disadvantages of recharacterisation is that such a security interest may be void for want of registration. (In practice an action for recharacterisation may be brought by the insolvency official of the collateral giver.)

Recharacterisation is considered in a very large number of cases under English law. This case law is generally robust, recognising a range of legitimate collateral techniques including outright transfers. Provided that parties use London standard documentation in accordance with its terms, recharacteristion risk is not considered to be significant under English domestic law. For a robust approach in avoiding recharacterising a repo transaction, see the full (unreported) judgment of Millett J in *Macmillan v Bishopsgate Investment Trust plc* (December 1993) at p. 113–115 (these comments do not appear in the abbreviated, reported version of the judgment at [1995] 3 All ER 747).

However the English domestic law position may not prevail even where the collateral document is governed by English law. First a foreign court may assume jurisdiction and apply foreign law. For this reason, the insolvency law of the collateral giver should be considered, and also possibly lex situs, as a third party creditor of the collateral giver may seek to bring an action there, attaching the collateral arrangements. Further it is also arguable that the English courts might themselves apply foreign law where foreign securities are involved. This would be on the basis that the English courts apply lex situs to determine property rights, and the question of whether an agreement is recharacterisable goes to the nature of the property rights of the collateral taker (outright title or a mere security interest). (For a fuller discussion see Benjamin, *Recharacterisation Risk and Conflict of Laws*, (1997) [JIBFI] 12 at p. 513–520.)



Therefore, although the analysis differs, the result in practice is the same for security interests and outright transfers; the collateral arrangements should always be tested under lex situs and insolvency jurisdiction as well as governing law.

LEX SITUS OF SECURITIES

Since all well-drafted collateral agreements have a governing law clause, governing law is generally readily identified. Where the collateral giver operates from its jurisdiction of incorporation, its insolvency jurisdiction is usually clear. Where the collateral giver acts through a branch, the prudent collateral taker will also check the insolvency law of branch jurisdiction. However identifying the lex situs of securities can be a challenge.

The lex situs of registered securities is generally determined by the location of the register (see *Dicey & Morris* at p. 931 and also *Macmillan Inc v Bishopsgate* [1996] 1 WLR 387 per Auld LJ at p. 411, *Brassard v Smith* [1925] AC 371 per Lord Dunedin at p. 376 and *Erie Beach Co v AG for Ontario* [1930] AC 161 per Lord Merrivale at p. 168.) In cases where share transfers are required to be recorded in a branch register, the location of the branch register and not the residence of the issuing corporation prevails as situs (*Brassard v Smith* [1925] AC 371).

As for negotiable bearer securities in traditional paper form, *Dicey & Morris* indicates that the situs of a negotiable instrument may differ according to the purpose for which it is being determined:

> *'The situs of the obligation could, therefore, depend on the question at issue ...'* (Rule 114(5), vol. 2, at p. 931).

This accords with the comments of Lord Lindley in *Commissioners of Inland Revenue v Muller & Co's Margarine Ltd* [1901] AC 217, at p. 237:

> *'It may perhaps be true that property which has no physical existence may, if necessary, be treated for some purposes in one locality, and for other purposes in some other locality.'*

For taxation purposes the situs of the security is the location from time to time of the instrument constituting it, following the general rule for chattels (Rule 114(5), vol 2, p. 930–931). For other purposes, however, the general rule for contract debts seems to be applicable to negotiable instruments, so that situs is the place where the debt security is enforceable, generally the residence of the debtor. *Dicey & Morris* cites *Re Clark* [1904] 1 Ch 29. See Farwell J at p. 208:

> *'With regard to the bonds, it is conceded that if they are on the same footing as simple contract debts the rule is, in construing a will, that the debts are, so far as they can have locality at all, be considered to be located where the debtor is resident; and for this purpose I do not see any ground for drawing a distinction between a bond and a simple contract debt.'*

This latter rule would appear to be appropriate when considering recharacterisation which concerns the nature of the property rights which may be enforceable against the collateral giver.

CONSIDERATIONS

It seems clear that governing law, insolvency jurisdiction law and lex situs should always be considered. The use of market standard opinions may assist greatly in avoiding fresh instructions to local lawyers each time collateral is taken. Also, the use of the international clearing systems may serve to avoid reference to an undue number of local jurisdictions, if situs can be associated with the clearer and not the underlying issue

The position changes when debt securities are immobilised in *Euroclear* and *Cedel Bank*. The key point is that the interest of participants is indirect, and is different from the underlying immobilised securities. The better approach is to identify situs with the office of the clearer where the account of the participant is maintained.

This approach can be supported by existing authority, by equating the databases of the clearers with the registers of registered securities in traditional form, or alternatively by showing that situs follows the practicalities of recovery and enforcement, and that immobilised securities are enforceable in practice through the clearers. Further, the interest of the participant arises under local statutory provisions in the clearer jurisdictions, and is governed by local law. This also supports a reference to the law of the clearer. In New York, this identification of situs with the intermediary clearer is achieved both by legislation (see s. 8–11 and 9–103(6) of the Revised Uniform Commercial Code) and independently by case law (*Fidelity Partners v First Trust Company of New York* 97 Civ. 5184 (SHS) (SDNY 1 Dec, 1997). The same approach is reflected in art. 9 (2) of the Finality Directive.

CONCLUSIONS

Taking cross-border securities, collateral is a complex legal operation and there is no quick fix. It is acknowledged that time and budgetary constraints dictate that it is not always possible to engage in full legal due diligence. However, it seems clear that governing law, insolvency jurisdiction law and lex situs should always be considered. The use of market standard opinions may assist greatly in avoiding fresh instructions to local lawyers each time collateral is taken. Also the use of the international clearing systems may serve to avoid reference to an undue number of local jurisdictions, if situs can be associated with the clearer and not the underlying issuer.

This last proposition rests, not on direct existing judicial authority, but on the view that English private international law is both dynamic and pragmatic, adapting flexibly to achieve a commercially appropriate result in changing circumstances. The courts have striven to make commercial sense by avoiding fragmentation in the past (*Cammell v Sewell* (1860) 5 H & N 728, per Crompton J at p. 1378; *Winkworth v Christie* [1980] 1 Ch 496, per Slade J at 512,3). The financial markets may feel able to trust that they will do so again.

Dr Joanna Benjamin
Deputy Chief Executive, Financial Law Panel