

SCHEDULE 2

ENGLAND

COUNTRY ANALYSIS

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1. General

1.1 Pledge – General Characteristics

Legal Mortgage:

- Full legal title is transferred to the collateral taker by way of security;
- Equity of redemption remains with the collateral giver, the collateral taker cannot transfer assets to third parties (different from the outright transfer).
- Unattractive alternative to outright transfer.; also its formality makes the equitable mortgage preferable.
- For transfer of legal title necessary to amend the register of the issuer.

Equitable Mortgage:

- Similar to the legal mortgage except that only equitable title is transferred to the collateral taker subject to equity of redemption.
- Not necessary to amend register of the issuer.
- Still some measure of paperwork involved, not being suitable for use where collateral pool changes-so a floating charge may be preferred.
- Creation over registered securities: by the deposit with the collateral taker of certificates and blank transfer forms.
- For registered securities the debtor should deposit the share certificates and an executed blank stock transfer form with the secured party and prior to an event of default; voting rights should not be exercised by the secured party; the dividends will go to the debtor (registered owner).

Fixed Charge:

- Confers right on the chargee to look to the asset for the discharge of the secured obligation.
- No transfer of title is involved to create the charge.
- Relates to ascertained assets; however it is possible to create a fixed charge over a changing class of assets, provided the chargor cannot remove an asset from that charged pool without the chargee's consent.
- Enforcement is by sale and registration may be required with the Registrar of Companies within 21 days of creation.

Floating Charge:

- Same first two characteristics as the fixed charge.
- Relates to a changing pool of assets where chargor retains freedom to deal with the assets.
- It does not attach to any specific asset until is crystallised into fixed charge.
- A floating charge is created when a charge is given over all securities from time to time in an account of the chargor at a clearing system leaving the chargor free to remove securities from the account without the chargee's consent.
- It ranks behind the fixed charge in terms of priority; it is always registrable with the Registrar of Companies within 21 days of creation; it takes effect subject to preferential creditors.
- Enforcement is by appointment of receiver and sale.

Pledge:

- Possession of tangible assets is given by way of security; so intangible property cannot be pledged because it cannot be possessed. All registered securities are intangible (Harrold v Plenty[1901] 2 Ch 314, where was held that a share cannot be pledged by deposit of the share certificate; so the physical certificate does not constitute a registered security, but merely evidences it).
- Most bearer securities used as cross-border collateral are held through ICSDs and represented by global notes in the hands of the local depositaries used by the clearers; so for the participants they are intangible. The pledge therefore is not appropriate for modern securities collateral arrangements.

1.2 Transfer of Title – General Characteristics

Alternative way of achieving the economic effect of security but avoiding the legal formalities of a charge.

- Collateral is provided by an outright transfer of title to the securities. The parties to this type of collateral are concerned to make sure that the title to the collateral securities is effectively transferred in accordance with the *lex situs*. In the case of securities held outside clearing systems, the *lex situs* of bearer securities is the location of the paper instrument constituting the security and for registered securities generally the place of incorporation of the issuer or if different the place where the register is maintained. In the case of securities held in ICSDs the position is still unclear, although academic writers favour the location of the ICSD or other intermediary where the rights of the collateral giver are recorded.
- In acquiring the outright title the collateral taker assumes the obligation to redeliver not the particular securities which he originally received but securities equivalent in all respects (number, type, amount and so on) with the original ones. The best English example is the 1995 ISDA Credit Support Annex Transfer which involves the

granter of the collateral taking a credit risk on the holder but relying for the protection on the availability of netting/set off procedures, so the holder's redelivering obligation will be converted if the party defaults, into an obligation to account for the monetary value of the collateral at the time of default, this can be included in the calculation of close out sums due under the related Master Agreement.

- Enforcement of collateral is by set-off. The redelivery date is accelerated to coincide with the date of default; the collateral taker's obligation to deliver equivalent securities is converted into an obligation to pay a cash amount equal to their market value; all cash amounts are converted into a base currency and all sums owed by one party to another under the arrangement are set-off against each other, so a net sum is payable and should be equal to the agreed excess of value of the collateral over the exposure of the collateral taker to the counterparty (margin). Whether set-off is available in insolvency will depend on the law governing that insolvency. In England set-off is mandatory (r.4.90 of the Insolvency Rules 1986).
- There is a risk that a court would not allow the collateral agreement to take effect according to its terms, and would recharacterise the interest of the collateral taker in the securities as a security interest instead of outright title. This is higher in cross border transactions, even if the governing law is English, because in some jurisdictions the structure may not comply with some requirements such as registration or notice. Consequences of the recharacterisation of the transfer as a security interest include: that the enforcement of a security interest may be stayed during administration or similar insolvency proceedings; the collateral giver may not have had power and authority to grant a security interest; and if the parties had contemplated the creation of a security interest, different provisions might have been stated in the documentation. Under English Domestic Law the recharacterisation risk is considered remote, provided that the documentation has been carefully drafted; the courts permit transactions to be structured in different ways to achieve the same net economic effect and are reluctant to categorise a transaction as something different from that which it purports to be under the documentation by which is created.

1.3 Considerations relevant to collateral arrangements

Pledge:

- To ensure that the lender has valid and enforceable security formalities for the creation and the perfection of that security needs to be checked and observed Principles of law in a number of jurisdictions may take place and conflicts need to be reconciled.
- With a floating charge there must be a limit on any rights of the borrower to substitute securities as this may render it a floating charge over the undertaking of the borrower, being registrable under S395 of the CA 1985.
- The borrower may be restricted in granting security interests by covenants or negative pledge clauses in third party arrangements.
- English insolvency rules can impose a "stay" on enforcement of security but

probably not on exercise of set-off rights where administration proceedings have commenced in England against a borrower.

- The secured party cannot freely use the charged securities, having only a partial proprietary interest. The chargor continues to own the securities, subject to this encumbrance. So unless specifically agreed (and even the effect of this is doubtful) the secured party cannot sell the securities, re-charge them or dispose of them, since all these would involve the ownership of securities passing from the chargor to a third party.
- A charge may be registrable with the Registrar of Companies under the registration of charges provisions of the Companies Act 1985. S395(which applies to UK companies and is applied to foreign companies in certain circumstances by section 409) requires the registration of certain types of charge described in section 396 of the Act. Failure to register within 21 days of its creation will render the charge void (and not merely voidable) against a liquidator, administrator or third party creditor of the chargor.
- The law is still somewhat unclear regarding aspects of perfection of securities held by a custodian or in a clearing system.

Transfer of Title

- The transferee is free to deal with the securities received under the arrangement because it is the owner; so the transferor is free to sell, lend and transfer them by way of security to another party.
- The parties do not need to concern themselves with the difficult issues associated with taking security over securities held by a custodian or any indirect holding system regarding the nature and location of collateral assets for determining perfection requirements, since the collateral transfer does not create a security interest.
- The documentation tends to be simpler, since there is no need for the elaborate provisions typically used with mortgages and charges on securities.
- The transferor always takes credit risk on the transferee. If the transferee defaults, the transferor should be able to set-off the value of the credit support originally transferred against its obligation under the related transactions. Insolvency law applicable to the transferee will dictate whether the netting or set-off works against the transferee.

With fungible securities, it is very unlikely that the transferor can obtain an order for specific performance to recover the securities from the defaulting transferee. The transferor's entitlement would be contractual (a debt claim) rather than a proprietary claim. It will be irrelevant to the transferor how or with whom the transferee holds the assets.

- Capital gains or similar taxes may apply because it may be viewed as an acquisition or disposal for this purpose. As to income tax, if the transferee passes back to the transferor income received on securities transferred, it could be charged to tax on

that income as its legal owner.

- Set-off is necessary to preserve the lender's net exposure. By interposing a third party custodian to hold the securities transferred, there can result problems with "mutuality" which do not arise if a security interest is used.

2. Private International Law and Domestic Law Aspects of Collateral

2.1 Validity of the Contract

English private international law:

- Material validity determined by the governing law of the collateral agreement;
- Constitutional power and capacity issues will generally be determined by the law of incorporation, though it may be limited by the governing law of the collateral contract.
- A contract will be valid if complies with the formal requirements of its governing law or the law where either party is located (provisions of Art. 9 of the European Convention, implemented by the Contracts Act 1990).
- As a proprietary matter, attachment should satisfy the *lex situs* of the collateral securities.

English domestic law:

- Requirement of consideration or value for contracts not executed as deeds.
- It is not necessary for the security document to be executed before a notary although it is usual for the document to be executed as a deed under seal which does not involve any public or formal process, such as payment of stamp taxes, but does involve the need for a written reference to the document being executed as a deed and the affixing to the document of the company's corporate seal or the signature of two of its directors or one director and the secretary. The execution of the document as a deed is not mandatory, but enables the pledgee to rely on certain powers to sell the collateral, which are simplified by statute in favour of the pledgee under a security document executed as a deed. However these powers can also be included through the express wording used in an ordinary contract between the pledgor and pledgee.

Indeed any evidence in written or otherwise, such as delivery of securities to be held as collateral into the pledgee's possession will be acceptable by the English Courts for the creation of a security interest so long as it sufficiently shows the pledgor's intention to create a security interest.

- The Memorandum of Association will be checked for good practice in cases of counterparties incorporated in the UK. No act by a UK corporate may be

called into question for lack of capacity by reason of anything in its memorandum of association (S35 of the CA 1985).

- Capacity of the executing individual to bind the company should be confirmed by a board resolution; however, when dealing with the board or an authorised person by the board, a party acting in good faith will be protected in the event that directors exceed their authority (35A and 35B, CA 1985).

A company will be contractually bound even if the agent executing it did not have actual authority if it had ostensible authority (principles of agency law).

- No special formal requirements for a collateral agreement under English Law. A purchaser or any person acquiring a security interest may assume due execution if the collateral agreement is purported to be signed by either a director and secretary or by two directors (36 A, CA 1985).
- Other possible restrictions on the ability to enter into a collateral agreement come from:
 - regulatory provisions (ex. S5 of the Financial Service Act 1986: which declares unenforceable any transaction entered into in breach of the restriction on unauthorised investment business);
 - company law (the need to show corporate benefit);
 - prior contractual arrangements (existence of negative pledge).

2.2 Perfection:

English private international law:

- Perfection will be governed by the lex situs, although reference to the law of incorporation or branch should be considered.

English domestic law:

There few perfection requirements:

- Any physical bearer security should be taken into actual or constructive possession;
- Where securities are held through intermediaries, they should be notified of the security interest;
- In the case of charges, the CA 1985 imposes registration requirements and the failure to comply with them may avoid a registrable security interest (strictly these do not represent a perfection requirement, as avoidance for want of registration operates against the liquidator or administrator of the counterparty, and not just third parties).

- No need to establish any separate account registrations or segregation procedures in respect of the creation of a security interest over securities located in the UK or governed by English law. However, where pledgor is de facto possession of the collateral then an English Court may consider that the security interest is only a “floating charge”.
- There is no fee of any kind to be paid upon filing or registration. The Registrar will return the original/copy of the document, together with a certificate of registration which is also entered on the Register of Charges and therefore available for inspection by member of the public.

2.3 Priorities

English private international law:

- The general rule in the case of successive security interests will be to apply the law governing the securities (the law of the forum as an alternative argument).
- Uncertainties can be mitigated by holding collateral through an ICSD, ensuring that a first priority security interest is taken in accordance to the Belgium and Luxembourg laws.

English domestic law:

- The rules for determining priorities are of great complexity: the first interest in time has priority subject to the following:
- Any equitable interest is overridden by a subsequent legal interest which has been acquired in good faith for value without notice of the equitable interest;
- A floating charge is overridden by a subsequent fixed charge, except when it prohibited the creation of subsequent fixed charges ranking ahead or together with the floating charge, giving the chargee actual notice of the prohibition at the time it took the charge;
- In cases of successive assignments of a debt or trust interest, the priority will be determined by the order in which notice of the assignment is given to the debtor.

2.4 Enforcement:

English private international law:

- The English courts will allow the enforcement over English securities arising under a foreign law agreement, so long as the requirements of English law as *lex situs* have been complied with.

English domestic law:

- Special care needs to be taken with the drafting of the collateral agreement: an inappropriate document will make the collateral taker rely on limited statutory rights of enforcement arising under the Law of Property Act 1925.
- In the case of securities collateral given by domestic corporate by way of security interest, the enforcement will be frozen if the collateral giver goes into administration (S 11(3)(c) of the Insolvency Act 1986).
- Some preliminary formalities are required:
 - Prior notice to the Counterparty provided that the security document has been prepared as to exclude the statutory restrictions on the exercise by the pledgee of its power of sale then any provisions in the security document dealing with the delivery of notices to the counterparty will be enforceable in accordance with their terms.
 - There is no need for minimum/maximum notice periods before further enforcement action can be taken or for any particular method to be specified for the service of notice.

2.5 Insolvency:

English private international law:

- Generally, insolvency is governed by the law of the jurisdiction in which the company is incorporated.
- English courts have jurisdiction to wind up any English registered or unregistered company when it is unable to pay its debts or if it is just and equitable to do so, according to the IA 1986 S 221 (5).
- English insolvency relates to assets wherever located (S 144, IA 1986), although in practice enforcement of English insolvency rules against foreign assets may be limited. The English courts may apply foreign law if requested by certain foreign (mainly Commonwealth) courts.
- Where insolvency proceedings in other jurisdictions are also involved, the English courts will look for some type of co-operation.
- Generally questions of priority arising from tracing actions will be governed by *lex situs* as was held in *Macmillan Inv v Bishopsgate Investment Trust plc* [1996] 1 WLR 387.

English domestic law:

- Insolvency law provides for different ways whereby the benefit of certain transactions such as the security arrangements entered into prior to the onset of insolvency proceedings may be undone or adjusted; clear examples are:

- undervalue situations (the insolvent party either received no consideration or insignificant consideration in return for the value which it provided (S 238, IA 1986));
- invalidation of security interests which constitute preferences in favour of some creditors (S 239);
- invalidation of floating charges in particular circumstances (S 245).
- The provisions of Part VII of the Companies Act 1989 (as amended) should be taken into consideration in respect of the insolvency of members of certain financial markets.
- In the case where the collateral securities are beneficially owned by a third party and their provision as collateral involves a breach of fiduciary duty by the collateral giver or a third party, the collateral taker will face the risk that the collateral securities may be reclaimed by or on behalf of the beneficial owners under a tracing action. Broadly speaking the collateral taker will be protected from the tracing where it advances money against the acquisition of legal title to the collateral securities bona fide and without notice (including constructive notice: the collateral taker is deemed to know what it ought reasonably to have known) of the breach of duty. The knowledge of responsible individuals within the corporation is attributed to the corporation in accordance with some rules.

3. Miscellaneous

3.1 Cross-border transactions in multi-tiered holding systems

The most suitable English collateral arrangement will vary depending upon the specific circumstances of the parties; they will need to measure the advantages and disadvantages of each arrangement. Initially collateral transfer seems to be the ideal collateral arrangement to follow: its structure does not involve the creation of a security, so issues of perfection of security, registration or notification requirements or similar formalities do not arise and obviously questions as to how to perfect security interest in securities held in a clearing system or other custodian arrangements are side-stepped; however on the other hand if there is a limitation or prohibition on insolvency set-off or netting in the home jurisdictions of one of the parties involved or a risk of recharacterisation, the security interest may be preferred.

The vast majority of securities are now held, transferred and pledged by book entry on the records of financial intermediaries, and not by physical delivery or registered pledge on the books of the issuer or its official record holder. The CSD will act as centralised holder of the securities issued in or for its domestic markets. The UK has centralised certain functions through a CSD that arranges to have transfers effected directly on the books of issuers or their transfer agents.

English law has traditionally been unclear as to which lex situs applies for book entry pledges of physical or dematerialised securities held through financial intermediaries in the modern international securities holding system.

Three or more intermediaries can often stand between an ultimate investor and the individual physical or dematerialised sec. For instance at a tier below the CSD there may be professional investors, brokers or other financial intermediaries (*participants*) with direct contractual relationships with the CSD which hold their interests in securities in book entry accounts with the CSD. These financial intermediaries in turn may hold interests in securities for lower tier investors, brokers and other financial intermediaries which will be their customers.

3.2. Implementation of the Settlement Finality Directive

Her Majesty's Treasury worked on the implementation on a confidential basis, considering the comments made out of the Draft "The Financial Markets and Insolvency (Settlement Finality) Regulations 1999", by financial institutions. An ad hoc working group comprising the representatives from the most important City Law firms, the Bank of England and academics recommended that Art. 9 (2) of the Directive should be given a broad scope in implementing the language, but the Treasury concluded that this was not possible without primary legislation.

The Treasury took the view that the implementation procedures of European Directives make it impossible to adopt a broad interpretation. This does not mean that they are closing doors to the possibility of this interpretation. However, they consider that this interpretation is beyond the scope of the Directive.

The ad hoc group of leading practitioners and academics dealing with this problem hopes that the provisions of the 1999 Regulations implementing Art. 9 (2) will be further supported by primary legislation, perhaps in the form of an additional clause to be included in the Financial Services and Markets Bill.