

BOOK REVIEW*

Cross Border Collateral: Legal Risk and the Conflict of Laws

RICHARD POTOK (ed)

(United Kingdom: Butterworths, 2002) pp xlv + 659 pages.

Recommended retail price £130.00 (ISBN 0 406 92941 6).

This is one of those rare gems in a legal reviewer's life: a specialist work with an appeal that transcends its speciality; an introduction to a nominally obscure area of law and practice, written with style and panache; a survey on a country-by-country basis that is actually enjoyable to read, as well as authoritative and useful; contributed by a gathering of true stars in its field. What is it all about?

In a few words, this book looks at a problem which arises in international banking transactions. The problem is significant. It concerns loans secured over international portfolios of shares and bonds, and arises when the borrower holds the securities not directly from the issuer, but through one or more layers of intermediaries (depository, trustee, custodian or nominee company). The context of the problem is that what the bank receives by way of security may not be proprietary rights over shares or bonds. Rather, they may receive claims (perhaps proprietary, perhaps contractual) against the intermediary or sub-intermediary who holds an interest in the securities registered in its books, or like claims against a higher level intermediary.

If the borrower grants security over its holding in the securities of a single issuer, there may be an opportunity for the bank to trace the nature of the borrower's interest or its claims against the intermediaries and, often through layers of intermediaries, trace that interest back to the issuer. If the borrower, bank, intermediary and issuer are all located in the same jurisdiction, the answer may be self-evident, familiar and relatively easy to determine.

Unfortunately, however, the actual circumstances of a typical transaction are more complicated and deny such simple analysis. For example:

- Borrowers more often than not offer an international portfolio of securities, issued from a range of jurisdictions, as security.
- Such securities are regularly held in book-entry accounts in sub-intermediaries, the original securities having been issued to another intermediary. The sub-intermediaries are not necessarily in the same jurisdiction as the intermediary and issuer. (For Euro-securities, the

* Peter Willis. LLB (Hons), BA (Hons) (Melb); Barrister, Melbourne; Co-rapporteur, International Committee on Securities Regulation of the International Law Association.

usual intermediaries, Euroclear and Clearstream,¹ in Belgium and Luxembourg respectively, are almost certainly in different jurisdictions from the issuer).

- The lender and borrower are equally likely to be in different jurisdictions both from each other and from the issuers and intermediaries.

Once any of these situations arise, complications develop. Should all of these situations arise simultaneously, the permutations for the law applicable to the validity and enforcement of the security become nightmarish.

The problem then is to determine the law applicable to the contracts and interests offered by way of security generally. More particularly, the problem is to determine the law(s) applicable to the perfection of the security interest taken by the lender and to the enforcement of its security. This is not just a simple exercise in finding the proper law of the loan contract or the mortgage or charge. Two things must be remembered. First, rights in property are involved, which are traditionally decided by reference to a system of law other than that of the contract, being the law of the location of the property or of the person dealing with it (the *lex situs* or *lex rei sitae*). Secondly, issuers of the underlying property concerned (securities) are scattered throughout the world.² In the insolvency of the borrower (or, indeed, of any other party), the law of incorporation of the insolvent party is sure to want to have a say.

New modes of business in issuing, recording and dealing with securities have developed in the past decade and a half, for which traditional conflicts principles have no ready answer.³ In part these stem from a recognition of the systemic risks in stock market settlement and transfer systems exposed by the October 1987 stock market crash. Following an influential study,⁴ stock markets and bond dealers worldwide moved to a 'delivery against payment' system of contemporaneous dealing and settlement (also known as 'T + 3', that is, 'day of trade plus three days until settlement'). These various developments encouraged the establishment and consolidation of, and cooperation between, international and national central securities depositories. They also created a new world of legal issues. This book wrestles with some of the most difficult of those issues.

The driving force for finding a solution to these issues at the international level can be attributed to the general editor of this work, Richard Potok, a

1 Until 1999, Clearstream was known as Cedel: Christophe Bernasconi, Richard Potok and Guy Morton, 'General Introduction: Legal Nature of Interests in Indirectly Held Securities and Resulting Conflict of Laws Analysis' in Richard Potok (ed), *Cross Border Collateral: Legal Risk and the Conflict of Laws* (2002) 7, 14 (fn 32).

2 Whether the security interest is in the underlying property or in some intermediate rights which trace ultimately to that property is, of course, a key question.

3 Bernasconi, Potok and Morton, above n 1, 47.

4 Group of Thirty ('G 30'), *Clearance and Settlement Systems in the World's Securities Markets* (1989). The report concluded that while 'the development of a single global clearing facility was not practicable' agreement on standards and practices among the world's major securities markets should be pursued. Relevantly, its detailed suggestions were to move away from certificated systems of securities ownership and transfer and towards the establishment of central securities depositories.

product of the University of New South Wales Law School.⁵ Building on the domestic regime recently developed in the United States ('US') to address security interests in new dematerialised securities,⁶ Potok and fellow Oxford graduate, Melbourne barrister Mark Moshinsky, formulated and propounded the solution to the conflict of laws problem⁷ which is now the focus of this book.

The book is up-to-the-minute. It records the present conditions in 25 relevant jurisdictions worldwide, covering all the major finance centres (other than France and Hong Kong) in both common law and civil law jurisdictions. The presentation is concise and the work is likely to be of lasting value, not just of immediate or transient interest. By the end of this year, a new international regime may be available in the form of the Hague Convention on Indirectly-Held Securities, a project of the Hague Conference on Private International Law ('Hague Conference'). The book is built around this Convention, now in its final draft and expected to be submitted to a diplomatic conference for adoption in December 2002. The Convention will need to be translated into national law for adoption. The book's coverage of national systems will provide practitioners with a way into those national systems both before and after adoption of the Hague Convention.

The opening and closing chapters explain the essence of the Convention helpfully and clearly. The Convention seeks to put forward a single test for determining the effectiveness of a dealing in indirectly-held securities, including priority disputes and enforcement. Under this test, courts of the forum have recourse to the law of the 'Place of the Relevant Intermediary', known by the happy acronym of PRIMA. That is, the court would not attempt to 'look through' a custodian to the next level of intermediary from whom it holds an interest or attempt to trace the security back to the issuer.⁸ Unless persuaded to adopt PRIMA as a matter of principle,⁹ the 'look through' approach would, in practical terms, involve the court in a multitude of enquiries, depending on the makeup of the portfolio of securities charged to the lender. Such an analysis leads (as the book repeatedly demonstrates) to inconsistent results depending on the law of the various issuers, all the while ignoring the practical position that the borrower and lender first and foremost deal with the relevant intermediary.

The book contains guest appearances from Lord Millett who contributes the foreword and from Sir Roy Goode, who provides a brief but authoritative

⁵ Sir Roy Goode, 'Overview' in Richard Potok (ed), *Cross Border Collateral: Legal Risk and the Conflict of Laws* (2002) 3, 3.

⁶ The National Conference of Commissioners on Uniform State Law and the American Law Institute, *The Uniform Commercial Code Article 8 – Investment Securities* (1994).

⁷ Richard Potok and Mark Moshinsky, 'Cross-Border Collateral: A Conceptual Framework for Choice of Law Situations' in Oxford Colloquium on Collateral and Conflict of Laws Special Supplement [1998] 13 *Butterworths Journal of International Banking and Finance Law* 10.

⁸ Cf *MacMillan Inc v Bishopsgate Investment Trust plc (No 3)* [1996] 1 WLR 387.

⁹ It has been adopted as such by Lawrence Collins (ed), *Dicey and Morris on the Conflict of Laws* (13th ed, 2000) [4-032].

overview in Chapter One.¹⁰ The most important chapter of the book is the General Introduction contributed by Christophe Bernasconi of the Permanent Secretariat to the Hague Conference, Potok, and Guy Morton of a leading London law firm. The chapter is based on a background paper prepared by Bernasconi with his co-authors for the Hague Conference. It tells the reader everything they need to know about the issues, the terminology, the structure of modern indirect holding systems for securities, the legal issues which arise (chiefly created by the commingling of interests in unidentified property) and the specific conflict of laws issues, including the range of possible approaches. In 40 pages, this chapter captures the work of a decade. Indeed, the material collected in the footnotes is a complete guide to the field. For once, an international text is truly international: the references cover French and German commentaries, as well as writings from the US and the UK.

While I have used Australian domestic concepts (charges or mortgages of securities) in my introductory description of the issues, the book itself employs 'neutral' language. Thus, the granting of a charge or other security interest becomes the granting of a 'pledge', used in a generic, non-technical sense and what is pledged is 'collateral'. The traditional direct holding of securities is contrasted with securities held by central security depositaries ('CSDs'). Australian readers have to take this part as given. But while our own domestic experience offers little insight into the issue, the chapter explains it clearly and authoritatively.

The book sets out four fact patterns to be used as the basis for discussion of the different legal systems. These deal with various means by which a borrower might grant a charge or transfer title to securities by way of security (that is, in the terminology of the book, pledge collateral by way of hypothecation or sale). Specialist authors from 25 jurisdictions then describe how their local law would deal with the facts, or might deal with the facts, highlighting the uncertainty which would be addressed by the Hague Convention. These authors are pre-eminent practitioners and scholars, often coming together in powerful combinations. For example, the Australian chapter is contributed by Potok, Moshinsky and Ted Kerr of Mallesons Stephen Jaques, Sydney. The UK chapter is written by Morton, Potok and Dr Joanna Benjamin, a UK specialist on custodianship. The UK chapter also includes an extended commentary on the adoption in *Dacey and Morris*¹¹ of the PRIMA concept as a special sub-rule for securities. The US chapter (based on the applicable law in New York) is prepared by another early proponent of PRIMA, Randall Guynn (of a leading New York law firm), and Professor James Rogers, the guiding hand in the drafting of the US domestic solution (the *Uniform Commercial Code – Article 8*:

¹⁰ See also Roy Goode, 'The Nature and Transfer of Rights in Dematerialised and Immobilised Securities' in Fidelis Oditah (ed), *The Future for the Global Securities Market: Legal and Regulatory Aspects* (1996) 107; [1996] 11 *Butterworths Journal of International Banking and Finance Law* 167.

¹¹ Collins (ed), above n 9, cited in Bernasconi, Potok and Morton, above n 1, 31 (fn 90).

Investment Securities).¹² It is difficult to fault the coverage and all the contributors are impressive. The editing is tight.

On the production side, my only gripe with a well-presented and packaged book is that, in the review copy at least, footnotes appear to be printed in grey or a tone lighter than the body text. I found this irritating, although a minor shortcoming in the broader scheme of things. Overall, I recommend this book to all who claim an interest in international finance law, conflict of laws or comparative law.

¹² The National Conference of Commissioners on Uniform State Law and the American Law Institute, *The Uniform Commercial Code Article 8 – Investment Securities* (1994).