II. Entwicklungen

A Need for a Change

The Undesirable Consequences of the Settlement Finality Directive and the Collateral Directive in the Field of Property and Insolvency Law, in Particular for Small- and Medium-Sized Enterprises

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I. Introduction

The European Settlement Finality Directive¹ was adopted in 1998. It relates to systems designed for the settlement of payments of cash and securities. One of the main goals of the Settlement Finality Directive is the elimination of systemic risk related to such systems. One speaks of systemic risk when a participant in the financial markets cannot fulfil its obligations, and when this default threatens to have a contagion effect on other market participants and jeopardizes the stability of the financial markets as a whole². The Settlement Finality Directive addresses this risk by setting out a uniform legal framework, which ensures that payment orders that have been entered into a system are "final" or irreversible. In addition, the Directive seeks to ensure the enforceability of the netting of payment orders by the different participants in the system. Another important issue relates to collateral arrangements entered into in order to secure obligations arising from participation in a system. The Directive intends to guarantee the enforceability of such collateral arrangements. The enforceability of payment orders, of the netting thereof and of collateral arrangements is crucial if systemic risk is to be prevented, particularly in the event of the insolvency of a participant in a system. To this end, the Settlement Finality Directive contains a number of provisions in the field of insolvency law. Under the regime of the Directive: 1) a declaration of insolvency

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¹ Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, O.J. 1998 L 166/45–50.

² The March 2003 Glossary of terms used in payment and settlement systems, issued by the Committee on Payment and Settlement Systems of the Bank for International Settlements, defines "systemic risk" as "the risk that failure of one participant in a transfer system, or in the financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their obligations (including settlement obligations in a transfer system) when due. Such failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of financial markets." For more information on systemic risk and further references see *Olivier de Bandt/Philipp Hartmann*, Systemic Risk: A Survey, November 2000, European Central Bank Working Paper Series No.35.

may not have retroactive force until the beginning of the day the declaration is issued (i.e. a so-called "zero hour rule" is no longer allowed); 2) legal acts are enforceable under certain circumstances, even after the declaration of insolvency; 3) a "stay" or "freeze period" may not be applied³.

Following the Settlement Finality Directive, the European legislator enacted the European Collateral Directive⁴ in 2002. This legislative initiative requires the harmonisation of a number of provisions of property and insolvency law relating to transactions with financial collateral (i.e. cash and/or securities). One of its main objectives is to improve the liquidity of the European markets for cash and securities. The elimination of legal uncertainty itself contributes to liquidity, and in addition a uniform legal regime throughout the European Union in relation to transactions involving financial collateral was designed to make it easier to enter into such transactions on a cross-border basis. In the field of insolvency law the provisions of the earlier Settlement Finality Directive paved the way for the approach adopted in the Collateral Directive. The Collateral Directive also 1) abolishes the "zero hour rule", 2) under certain circumstances allows the enforceability of legal acts entered into after the declaration of insolvency, and 3) does not allow the application of a "freeze period" to financial collateral arrangements. The Collateral Directive, however, goes beyond the boundaries of insolvency law and also contains a number of general civil law provisions, particularly in relation to the law on property. In this field the Collateral Directive provides among other things for 4) the recognition of title transfers in accordance with their contractual terms; 5) the enforceability of close-out netting agreements; 6) the device of a security interest combined with a security taker's general right of disposal; 7) a simplified regime for the enforcement of security interests⁵.

The scope of the Collateral Directive is considerably broader than that of the Settlement Finality Directive. Whereas the Settlement Finality Directive, broadly

³ For more information about the Settlement Finality Directive see Marc Vereecken/Albert Nijenhuis (eds.), *Settlement Finality in the European Union, The EU Directive and Its Implementation in Selected Jurisdictions*, Deventer, 2003; Roy Goode/Herbert Kronke/Ewan McKendrick/Jeffrey Wool, *Transnational Commercial Law, International Instruments and Commentary*, Oxford, 2004, chapter 9; Caroline Pitt, *Improving the Legal Basis for Settlement Finality*, (2003) 18 (9) *Butterworths Journal of International Banking and Financial Law* (BJIBFL) 341–345; Erica Johansson, *Transfer and Settlement of Securities: The New Order*, (2005) 16 (5) *European Business Law Review* (EBLR) 1093–1115, in particular section 4.

⁴ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, O.J. 2002 L 168/43–50.

⁵ See on the Collateral Directive for example James Cooley, *New Protections For Cross-Border Collateral Arrangements: Summary and Analysis of Draft E.U. Directive on Financial Collateral*, (2001) 16 (5) *Journal of International Banking Law* (JIBL) 119–124; Dermot Turing, *The EU Collateral Directive*, (2002) 17 (5) BJIBFL 187–188; Goode/Kronke/McKendrick/Wool (n.3) chapter 9; Johansson, (2005) 16 (5) EBLR, in particular section 3. For individual country reports on the implementation of the Collateral Directive see for example the (2004) 19 (1) *Journal of International Banking Law and Regulation* (JIBLR) 12–16 (Finland); (2004) 19 (12) JIBLR 510–512 (Italy); (2005) 20 (2) JIBLR 65–71 (United Kingdom); (2005) 20 (2) JIBLR 72–78 (Germany); (2005) 20 (5) JIBLR 222–229 (Belgium); (2005) 20 (6) JIBLR 295–299 (United Kingdom); (2005) 20 (7) JIBLR N 54 – N 57 (Poland); and the (2004) 19 (2) BJIBFL 63 (Denmark); (2004) 19 (4) BJIBFL 148–149 (Ireland); (2005) 20 (1) BJIBFL 4–9 (United Kingdom); (2005) 20 (3) BJIBFL 114–115 (Poland); (2005) 20 (3) BJIBFL 116–117 (Spain); (2005) 20 (4) BJIBFL 147–148 (Belgium); (2005) 20 (6) BJIBFL 234–235 (Ireland, United Kingdom).

speaking, relates only to systems in which payments of cash and securities are settled and to the participants in those systems⁶, the Collateral Directive applies to nearly all major players on the financial markets, including commercial and central banks, public authorities, investment firms and insurance companies⁷. The Collateral Directive's regime, however, is not limited to these major participants in the financial markets, but also applies as a principle to other entities, such as small- and medium sized enterprises, if they enter into transactions with a major market participant⁸. The only transactions not falling under the Directive are those between the entities mentioned in Article 1 (2) (e) of the Collateral Directive (e.g. small- and medium-sized enterprises) and transactions involving natural persons. Member States do have the option of excluding transactions between major financial institutions and small- and medium-sized enterprises from the scope of the national rules implementing the Collateral Directive⁹. However, few Member States appear to have made use of this so-called "opt-out" clause¹⁰.

At the end of 2005, the Commission of the European Communities issued an evaluation report on the Settlement Finality Directive, as implemented by 25 Member States. The report identifies a number of issues for improvement and is intended as a starting point for a dialogue to be initiated by the Commission in 2006 involving Member States and the European Central Bank. The Commission intends that this dialogue will determine if and how the Directive should be amended¹¹. Work on a similar evaluation report has been initiated in relation to the implementation of the Collateral Directive. According to Article 10 of the Collateral Directive, this report should be presented to the European Parliament and the Council no later than 27 December 2006. These evaluations provide a good opportunity to take a critical look at the two Directives¹².

Section II below outlines the rules of property and insolvency law set out in the Settlement Finality Directive and the Collateral Directive. First, attention will be paid to the rules of property law set out in the Collateral Directive. As mentioned above, this Directive has a number of consequences for title transfers of financial collateral, and for security interests in respect thereof. Subsequently, this section will examine the provisions of the Settlement Finality Directive and the Collateral Directive that require that national regulations relating to insolvency be harmonized. In this section attention will also be paid to comparable developments set out

⁶ See Article 1 of the Settlement Finality Directive. Note that the Directive also applies to collateral security provided in connection with operations of central banks of the Member States in their function as central banks.

⁷ For a precise enumeration see Article 1 (2) (a) – (d) of the Collateral Directive.

⁸ See Article 1 (2) (e) of the Collateral Directive.

⁹ See Article 1 (3) of the Collateral Directive.

¹⁰ See for more information section III.2 below.

¹¹ See Commission of the European Communities, Report from the Commission, Evaluation report on the Settlement Finality Directive 98/26/EC, Brussels, 2005, (available on http://europa.eu.int/comm/internal_market/financial-markets/index_en.htm).

¹² See on the evaluation of the Directives: EU Clearing and Settlement – Legal Certainty Group, Synthesis Report of the meeting held on 31 January 2005, MARKT/G2/D(2005), section 2.2.

in a UNIDROIT Preliminary Draft Convention on Harmonised Substantive Rules regarding Intermediated Securities.

The European legislator has harmonised the legal regulations relating to settlement systems and transactions with financial collateral throughout the European Union, with the aim of realising such commendable objectives as the elimination of systemic risk, ensuring legal certainty and a liquid European market for cash and securities. One should, however, question whether the rules set out in the Directives are fair to all the parties involved, and if the harmonised regime should not have been slightly different. Because of the wide scope of the Collateral Directive, it is particularly important to examine the effects of the new rules of property and insolvency law on weaker economic actors, such as small- and medium-sized enterprises. Section III suggests that a number of changes be introduced, resulting in a slightly different regime, which meets the objectives relating to systemic risk, legal certainty and liquidity, but which at the same time does more justice to the divergent interests of the different actors in the financial markets.

II. Far-reaching consequences for property and insolvency law

1. Introduction

This section outlines the key consequences of the Collateral Directive and the Settlement Finality Directive for property and insolvency law. In order to improve liquidity, the Collateral Directive sanctions title transfers of financial collateral, introduces a security interest combined with a so-called “right of use” (i.e. a collateral taker’s general right of disposal), and contains provisions relating to the enforcement of financial collateral (whether provided by way of an outright transfer or on the basis of a security interest). These topics will be discussed in section 2 below. In addition, both the Collateral Directive and the Settlement Finality Directive set out a number of provisions of insolvency law, which will be the subject of section 3. Section 4 will assess whether the Directives in their current form strike a fair balance between the interests of collateral providers, their creditors, and collateral takers, and – in the case of insolvency – between the different creditors of the insolvent estate.

2. Property law

The Collateral Directive distinguishes between title transfers and security interests. This distinction will be used in order to outline the most important consequences of the Collateral Directive in the field of property law.

In practice, financial collateral is often provided on the basis of an outright transfer of title¹³. An outright transfer, i.e. an unlimited transfer of all right, title

¹³ This happens for example on the basis of market documentation for repurchase, securities lending and derivatives transactions applied in Europe, such as the Global Master Repurchase Agreement (GMRA), the

and interest in respect of such collateral, enables the collateral taker to dispose of the collateral in the course of his own business. If the collateral taker only needs an object for recourse in order to secure an outstanding debt, the collateral provider can provide one by establishing a security interest in respect of financial collateral. This security interest can, for example, – depending on the national legal system – be a right of pledge or a fiduciary transfer of title.

a) Transfer of title

aa) Transfer of title enforceable in accordance with contractual terms

Article 6 of the Collateral Directive determines that title transfer arrangements can take effect in accordance with their terms. Section 1 of this provision reads as follows: “Member States shall ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms.”

This provision sanctions outright transfers of financial collateral, which enable the collateral taker to dispose of the collateral in the course of his own business. In addition, if interpreted extensively, this provision also sanctions fiduciary transfers of title which aim to provide security and do not give the collateral taker the right to dispose freely of the collateral. Such an extensive interpretation would, however, have negative consequences for collateral providers.

A fiduciary transfer of title is essentially a security interest. For this reason, provisions and principles of pledge law are traditionally applied by way of analogy to such fiduciary transfers¹⁴. Applying the rules of pledge law, such as those relating to a conditioned manner of enforcement (e.g. a public sale, or a sale involving intervention by a judge or another objective, third party intermediary) and prohibiting appropriation, guarantees a balance between the interests of the collateral provider (and its creditors) and the collateral taker. The principle that any surplus value upon enforcement by the collateral taker should be paid to the collateral provider has the same effect. The application of these rules shapes the fiduciary relationship between the parties. They guarantee maximum proceeds and protect the collateral provider and its creditors against a more powerful collateral taker. The application of these principles of pledge law is particularly important in a situation in which there is no equal balance of power between the credit provider and the debtor providing the collateral. Normally, therefore, these principles are applied in a mandatory fashion.

Global Master Securities Lending Agreement (GMSLA), the Margin Provisions (Part 3; English law) issued by the International Swaps and Derivatives Association (ISDA), and the European Master Agreement for Financial Transactions (EMA).

¹⁴ This, for example, is the case under (old) Dutch law. To a certain extent the same is true for current German law. See on old Dutch law e.g. *Antonius van Mierlo*, *Fiduciaire zekerheid, vuistloos en stil pand*, Deventer, 1988; and on current German law e.g. *Jürgen Baur/Rolf Stürmer*, *Sachenrecht*, 17th edition, 1999, §§ 57 and 58, and *Rolf Serick*, *Securities in Movables in German Law: An Outline*, Deventer, 1990. Note that as from 1992 fiduciary transfers of title are prohibited under Dutch law by Article 3:84(3) of the Dutch Civil Code. This provision was interpreted by the Dutch Supreme Court (*Hoge Raad*) in the “Sogelease” case of 19 May 1995, *Nederlandse Jurisprudentie* 1996/119, and in the “B.T.L. Lease” case of 18 November 2005, www.rechtspraak.nl, LJN AT8241. Under current Dutch law a security interest can in any case be established by vesting a (public or non-public) right of pledge.

In line with Article 6 of the Collateral Directive – if interpreted extensively – the parties can render these principles inoperable in a contract. According to Article 6 it would, for example, be possible to agree that the collateral taker/fiduciary has the right to appropriate the encumbered assets upon default. It can also be agreed that, if he chooses to sell them, he is not obliged to do so in a predetermined manner, but may do so as he deems fit. He may also not be obliged to pay any surplus value to the collateral provider. Maximum proceeds for the benefit of the collateral provider and his other creditors are clearly not guaranteed in this scenario. In short, the consequence of an extensive interpretation of Article 6 of the Collateral Directive would be that the parties can, in a contract, depart from protection mechanisms of pledge law, which are traditionally applied by way of analogy to fiduciary transfers.

bb) Close-out netting

Close-out netting provisions commonly form part of title transfer financial collateral arrangements. Such provisions take effect automatically or upon notice in the event of a default (or other comparable event) occurring on the part of one of the parties to the arrangement. In short, close-out netting provisions aim at 1) the early termination of the contractual relationship between the parties and acceleration of all outstanding obligations thereunder, 2) the valuation of these obligations in monetary terms, and, if necessary, conversion of cash sums due into one single currency, 3) and subsequent set-off. This results in a single net amount payable by one of the parties¹⁵.

Generally, Article 7 of the Collateral Directive sanctions the enforceability of such close-out netting provisions in financial collateral arrangements. Section 1 of this provision requires Member States to ensure “that a close-out netting provision can take effect in accordance with its terms”. Nevertheless, recital 15 of the Directive makes clear that some crucial issues still need to be determined by national law, such as the question of whether the obligations that are subject to close-out netting are reciprocal and the question of whether close-out netting is enforceable in the light of rules on voidable preference (*actio pauliana*)¹⁶.

b) Security interests

aa) Security interest combined with a “right of use”

One of the most remarkable changes brought about by the Collateral Directive is set out in Article 5. This provision envisages the possibility of combining a security interest with a “right of use”, i.e. a general right of disposal for the collateral taker. Morton and Potok have proposed that this device should form part of the Collateral Directive¹⁷. One of the main objectives of introducing a collateral

¹⁵ See for example Paragraph 10 of the GMRA, the Paragraphs 9, 10 and 14 of the GMSLA, the Sections 5 and 6 of the ISDA 2002 Master Agreement and the Sections 6 and 7 of the EMA General Provisions.

¹⁶ See on the issue of voidable preference also recital 16 and Article 8(4) of the Collateral Directive.

¹⁷ See the position papers by Guy Morton and Richard Potok, in: European Commission (Internal Market

taker's right of use is enhancing the liquidity of the cash and securities markets. If a collateral taker can dispose of encumbered assets regardless of the circumstances, the result is greater liquidity¹⁸. Morton and Potok appear to have been inspired by American law. Over the past twenty years or so, a security interest combined with an unlimited right of disposal has become a common device in the American derivatives and securities lending markets¹⁹. Section 1 of Article 5 of the Collateral Directive states:

„If and to the extent that the terms of a security financial collateral arrangement so provide, Member States shall ensure that the collateral taker is entitled to exercise a right of use in relation to financial collateral provided under the security financial collateral arrangement.”

A “right of use” is defined in Article 2(1)(m) of the Collateral Directive as

„the right of the collateral taker to use and dispose of financial collateral provided under a security financial collateral arrangement as the owner of it in accordance with the terms of the security financial collateral arrangement”.

If the collateral taker executes this right of use, for example by transferring the collateral assets to a third party, the collateral provider loses his (proprietary) interest in the collateral²⁰, and is left with a contractual claim in relation to the collateral taker. By exercising the right of use the collateral taker incurs a contractual obligation to transfer equivalent assets to the collateral provider, no later than at the end of the transaction. On the basis of Article 5(3) of the Collateral Directive these equivalent assets take the place of the assets originally provided (i.e. a rule of proprietary substitution). The text of this provision reads as follows:

„The equivalent collateral transferred in discharge of an obligation as described in paragraph 2, first subparagraph, shall be subject to the same security financial collateral agreement to which the original financial collateral was subject and shall be treated as having been provided under the security financial collateral arrangement at the same time as the original financial collateral was first provided.”

This rule of proprietary substitution, however, has a downside. It only relates to equivalent assets, and not to any assets replacing the original collateral assets (e.g. the sale proceeds). Moreover, it takes effect only when the collateral taker decides that he will transfer the equivalent assets, and not at the point that they become part of the collateral taker's estate. If the equivalent assets are transferred at the

DG, Financial Services, Financial Transactions and Payment Systems), Working Document on Collateral from the Commission to relevant bodies for consultation (including a first preliminary draft proposal for a Directive), Brussels, 15 June 2000, Annex A and Annex B. See also *Joanna Benjamin*, *Interests in Securities*, A Proprietary Law Analysis of the International Securities Markets, Oxford, 2000, sections 5.46–5.70.

¹⁸ See for example recital 19 of the Collateral Directive.

¹⁹ See on the history of the device of “rehypothecation” or “repledge”, and on the dogmatic problems it causes under American law: *Christian Johnson*, *Derivatives and Rehypothecation Failure: It's 3:00 p.m., Do You Know Where Your Collateral Is?*, (1997) 39 *Arizona Law Review* (Ariz. L. Rev.) 949–1001; *Kenneth Kettering*, *Repledge and Pre-Default Sale of Securities Collateral Under Revised Article 9*, (1999) 74(3) *Chicago-Kent Law Review* (Chi.-Kent L. Rev.) 1109–1155; *Kenneth Kettering*, *Repledge Deconstructed*, (1999) 61 *University of Pittsburgh Law Review* (U. Pitt. L. Rev.) 45–239.

²⁰ In the European Union interests in securities are often of a proprietary nature. See for example the Report of the European Financial Market Lawyers Group (EFMLG), *Harmonisation of the Legal Framework for Rights Evidenced by Book-Entries in respect of Certain Financial Instruments in the European Union*, June 2003.

same time that the secured debt is paid off, as will usually be the case, no proprietary substitution takes place at all. This is because, in line with the accessory character of security interests, the collateral taker's security interest ceases to exist when the secured debt is fulfilled. As a result the collateral provider is left with a contractual claim as of the moment that the right of use is exercised until the moment that the collateral taker transfers equivalent assets, usually at the end of a transaction. During this period the collateral provider runs an insolvency risk in relation to the collateral taker²¹.

The Collateral Directive's right of use is not compatible with the traditional approach of security interests. Security interests, such as a right of pledge, customarily relate to assets that can be used for recourse purposes, if a secured debt is not satisfied. Under "normal", i.e. non-default circumstances the encumbered assets cannot generally be used for other purposes, such as in the case of a right of usufruct, let alone be disposed of. The device of a general right of disposal is also not in line with the secured party's duty of good care in relation to the assets in which he has a security interest. The device conflicts with the ban on appropriating encumbered assets that applies in a number of Member States. Besides, it frustrates the collateral provider's right of redemption, which means that he regains full title to the encumbered assets if he pays the secured debt. These traditional principles guarantee a balance between collateral provider and collateral taker, which is disturbed by the Collateral Directive. The fiduciary character of a security interest, which protects the interests of collateral providers and their creditors against those of often stronger collateral takers, is not in line with a collateral taker's general right of disposal, which is in fact a right to end the fiduciary relationship between the parties.

A report on the right of use, presented to the UNIDROIT Secretariat in July 2003 by a group of independent academics and practitioners, submits that under American, English, Danish, Italian, Dutch, and German law a security interest combined with a right of use is essentially an outright transfer. Under English law, for example, a collateral taker's general right of disposal is not compatible with equitable rules, in particular the collateral provider's equity of redemption. Accordingly, a security interest combined with a "right of use" should, according to the general principles of English law, be characterised as an outright transfer. Under, for example, Italian, Dutch, and German law, the device of a security interest combined with a general right of disposal can best be understood by referring to the device of the irregular right of pledge or *pignus irregulare*. Such an irregular right of pledge entails a passing of ownership. The irregular right of pledge applies the principle that ownership passes from one party to another when assets are rendered replaceable. This occurs when a non-owner (e.g. a pledgee, a usufructuary or a borrower of fungible assets) is given the right to

²¹ This risk is mitigated if the collateral provider can offset his right to receive equivalent assets with his obligation towards the collateral taker to fulfill the secured debt. However, in the case of price fluctuations of the cash and/or securities involved a residual risk may remain outstanding.

dispose of the assets involved, and is under an obligation to return equivalent assets to the original owner. In the case of the Collateral Directive's right of use, assets are essentially made replaceable, which would under general principles of law lead to a passing of outright title²².

Combining a security interest with a right of use benefits liquid markets. However, it puts a collateral provider in an undesirable position, leaving him with a contractual claim towards the collateral taker. Besides, the right of use infringes upon a number of core principles of pledge law, such as the duty of good care, the prohibition of appropriation, and the right of redemption. It is not in line with the fiduciary nature of security interests. It could, therefore, be argued that the device should for e.g. tax, accounting and capital adequacy purposes be treated as what it is in material terms, i.e. as an outright transfer. In addition, it should be noted that the goal of liquidity could also have been reached without blurring the distinction between outright transfers and security interests. It would have been better if the Collateral Directive had been limited to sanctioning the outright transfer technique²³.

bb) Liberal enforcement regime

Article 4 of the Collateral Directive envisages a liberal enforcement regime of security interests, such as a right of pledge. In the event of default by a collateral provider, who has provided collateral on the basis of a security interest, the collateral taker can enforce his security interest without formalities such as a public sale or the intervention of an impartial intermediary. This follows from Article 4 (4), which states:

„The manners of realising the financial collateral referred to in paragraph 1 shall, subject to the terms agreed in the security financial collateral arrangement, be without any requirement to the effect that: (a) prior notice of the intention to realise must have been given; (b) the terms of the realisation be approved by any court, public officer or other person; (c) the realisation be conducted by public auction or in any other prescribed manner; or (d) any additional time period must have elapsed.”

Moreover, Article 4 (1) – (3) of the Collateral Directive takes the non-applicability of the prohibition of appropriation as a starting point. This means that the collateral taker can, if this has been agreed by the parties, appropriate assets upon default and value them on the basis of a contractual arrangement. The aim of combining mandatory enforcement formalities with the prohibition of appropriation is to ensure maximum proceeds. As such, the interests of collateral providers and their creditors are taken into account. Under the regime of the Collateral Directive these protection mechanisms can be rendered inapplicable on the grounds of a contract²⁴.

²² See for a more elaborate discussion and further references the Report on a “Right of Use” for Collateral Takers and Custodians; Presented to the UNIDROIT Secretariat, Rome, July 2003, (available on <http://ideas.repec.org>).

²³ See on the device of a collateral taker's general right of disposal also *Johansson*, (2005) 16 (5) EBLR, section 3.4.

²⁴ See also section II.2.a.aa (“Transfer of title enforceable in accordance with contractual terms”) above.

There should be a good reason to deviate from the strict rules guaranteeing maximum proceeds in the case of a security interest being enforced and to depart from mandatory principles of pledge law. The liberal enforcement regime of the Collateral Directive is justified with the argument that it guarantees the continued liquidity of the cash and securities markets, and as such limits systemic risk. In addition, a reasonable valuation of collateral is likely to occur in transactions between major, equally powerful market participants. Besides, the Collateral Directive allows for national rules that give a judge the possibility to check *a posteriori* if valuation of collateral has taken place on a commercially reasonable basis²⁵. These arguments are convincing in relation to major market participants and in this case they justify the Collateral Directive's liberal enforcement regime.

The Collateral Directive, however, is not fair to small- and medium-sized enterprises. There is a clear imbalance of power between these players and major market participants. In addition, small- and medium-sized enterprises have very limited impact on the liquidity of the cash and securities markets. The liberal enforcement regime of the Collateral Directive fails to take into account their interests and those of their creditors in a satisfactory way. Maximum proceeds are not guaranteed if valuation mechanisms are determined in a contract, the terms of which may be dictated by the credit provider/collateral taker. Moreover, it may be difficult for a small- or medium-sized enterprise to determine whether it is feasible to start legal proceedings against a collateral taker after enforcement has taken place, if it lacks expertise and direct access to accurate information about fair prices for financial collateral²⁶. The Collateral Directive should therefore not be applied to small- and medium-sized enterprises.

cc) Undesirable developments

The European legislator's liberal approach towards security interests is unfortunate. It is particularly disadvantageous to small- and medium-sized enterprises. The right of use will usually leave them with a contractual claim throughout the course of a transaction. Moreover, the legal mechanisms guaranteeing the realisation of maximum proceeds when a right of pledge or a fiduciary ownership right is enforced, are rendered inactive.

It is interesting to note that UNIDROIT is currently working on a draft international Convention on Harmonised Substantive Rules regarding Intermediated Securities and proposes a comparable approach with regard to security interests. Article 22 of the May/June 2005 Preliminary Draft Convention relates to the enforcement of security interests over intermediated securities. This provision – like the Collateral Directive – sets out a liberal enforcement regime of security interests which can be determined in an agreement between the parties and is not subject to national mandatory rules relating to enforcement²⁷. The only require-

²⁵ See recital 17 and Article 4 (6) of the Collateral Directive.

²⁶ Securities are not necessarily listed on exchanges with transparent prices. They may for example also be traded on alternative trading platforms or on the over-the-counter market, where prices may diverge.

²⁷ See UNIDROIT 2005, Study LXXVIII – Doc. 24, June 2005, Appendix 2, Article 22.

ment allowed is that enforcement takes place in a commercially reasonable manner²⁸. This requirement may prove useful in transactions between major market participants, but, as mentioned above, its value is limited in the case of small entities that have no or only limited access to relevant information about market prices. Article 23 of the May/June 2005 Preliminary Draft Convention relates to the collateral taker's right to use collateral securities, which means that he, if so agreed, has an unlimited right of disposal in respect of such securities. The usual effect of such "use" is that the collateral provider is left with a contractual claim towards the collateral taker throughout the course of a transaction²⁹. The draft UNIDROIT Convention, as a principle, has a wide scope of application. Only with the explicit declaration of a Contracting State do the provisions identified above not apply³⁰. In its current form, the draft UNIDROIT Convention, like the Collateral Directive, therefore fails to pay sufficient attention to the position of weaker economic actors, who may be faced with a disadvantageous enforcement regime and, in the case of a right of use, a mere contractual claim against the collateral taker.

3. Insolvency law

The Settlement Finality Directive and the Collateral Directive contain a number of provisions of insolvency law which have a potentially negative impact on the size of the estate of an insolvent entity. The changes are advantageous to the insolvent entity's counterpart in a system or under a collateral arrangement and to the detriment of the insolvent entity's other creditors. In the discussion below, the main focus will be on the Collateral Directive, whereas the relevant comparable provisions of the Settlement Finality Directive will be referred to in footnotes.

a) No retroactive force of the declaration of insolvency

The Collateral Directive, like the Settlement Finality Directive, does not recognise the retroactive force of a court's declaration of insolvency timed from the beginning of the day that the insolvency is declared (the so-called "zero hour rule"). This means that under the regime of these Directives, insolvency takes effect from the precise moment that the insolvency is declared. Article 8(1)(a) of the Collateral Directive states:

„Member States shall ensure that a financial collateral arrangement, as well as the provision of financial collateral under such arrangement, may not be declared invalid or void or be reversed on the sole basis that the financial collateral arrangement has come into existence, or the financial collateral has been provided [...] on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement.”³¹

²⁸ See UNIDROIT 2005, Study LXXVIII – Doc. 24, June 2005, Appendix 2, Article 22(5).

²⁹ See UNIDROIT 2005, Study LXXVIII – Doc. 24, June 2005, Appendix 2, Article 23.

³⁰ See UNIDROIT 2005, Study LXXVIII – Doc. 24, June 2005, Appendix 2, Article 25.

³¹ See also the Articles 3, 6 and 7 of the Settlement Finality Directive.

On the basis of this provision, money and securities paid by the insolvent party on the day of the declaration of insolvency, but before the exact moment of that declaration, fall outside the insolvent estate. This may be disadvantageous to the insolvent estate and its other creditors in those Member States in which an insolvency declaration has retroactive force, but it is a fair rule. The Collateral Directive accurately applies the principle that fixation of the insolvent estate takes place at the moment the insolvency is declared.

b) Enforceability of legal acts after the declaration of insolvency

The Settlement Finality Directive and the Collateral Directive allow an insolvent entity's counterpart in a system or under a financial collateral arrangement to invoke provisions protecting his interests in respect of legal acts performed on the day of, but after the moment of the declaration of insolvency. The counterpart can only successfully do so if he can prove that he was not aware nor should have been aware of the insolvency. Article 8(2) of the Collateral Directive states:

„Member States shall ensure that where a financial collateral arrangement or a relevant financial obligation has come into existence, or financial collateral has been provided on the day of, but after the moment of the commencement of, winding-up proceedings or reorganisation measures, it shall be legally enforceable and binding on third parties if the collateral taker can prove that he was not aware, nor should have been aware, of the commencement of such proceedings or measures.”³²

The argument used to justify this rule is the need to eliminate systemic risk. The counterpart of an insolvent entity in a system or under a collateral arrangement must be sure that payments of cash or securities cannot be reversed, even if they have been carried out after the declaration of insolvency. Otherwise, this may result in a default by that insolvent entity's counterpart, possible contagion effects on other market participants, and thus systemic risk.

How convincing is this argument? The rule seems relevant only in a limited number of cases. Vereecken presents two examples of a financial institution that transfers assets after a declaration of insolvency. He mentions a foreign branch of a financial institution, which transfers assets not knowing that the institution has been declared insolvent according to the laws of another jurisdiction. He also shows that a financial institution may carry out transactions in the name and for the account of another institution that has in the meantime been declared insolvent³³. These are exceptional cases, which do of course cause inconvenience, but which can hardly be deemed to pose a systemic risk to the entire financial sector. It should be taken into account that in the financial markets information about an (upcoming) insolvency is generally made available immediately, for example by supervisors or rating agencies. This circumstance not only makes legal acts by a (foreign) branch or on the basis of a power of attorney unlikely, but also makes it hard for the insolvent entity's counterpart to invoke “good faith”. In the case of transactions involving small- and medium-sized enterprises such information is

³² See also Article 3 of the Settlement Finality Directive.

³³ See Vereecken/Nijenhuis (n.3) 46–47.

less readily available. But even here, legal acts entered into after the declaration of insolvency cannot be considered to trigger systemic risk. As a result of their size, the non-enforceability of transactions entered into by small- and medium-sized enterprises is unlikely to cause contagion effects and pose a danger to the entire financial sector.

Moreover, the rule set out in the Settlement Finality Directive and the Collateral Directive fails to conform to the general principle of insolvency law that legal acts conducted after the declaration of insolvency are not enforceable (i.e. the principle of fixation of the insolvent estate). Neither is the rule of the Directives in line with the related *pari passu* or *paritas creditorum* rule, which intends to protect the interests of the joint creditors of the insolvent estate against the single interest of an individual creditor invoking protective provisions. The approach of the Settlement Finality Directive and the Collateral Directive means that the insolvent estate and its joint creditors are put in a disadvantageous position to the benefit of an individual creditor. Another circumstance that should be taken into account is that the rules of the Directives can be misused to the detriment of all other creditors by an insolvent entity which wishes to favour a counterpart that is unaware of the declaration of insolvency.

All in all, the argument of systemic risk hardly seems to be sufficient grounds to deviate from the fixation and *pari passu* principles that apply in insolvency, also taking into account the possible misuse of the rule that envisages the enforceability of legal acts even after the declaration of insolvency.

c) “Freeze periods” not applicable

The Settlement Finality Directive and the Collateral Directive render inoperable temporary “freeze periods” under national insolvency law during which (secured) creditors cannot execute their rights. The Collateral Directive states in general terms in Articles 4 (5) and 7 (1) (a) that a financial collateral arrangement can take effect “notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures”. Besides these general provisions that exclude the applicability of a “freeze period”, Article 4 (4) (d) of the Collateral Directive (quoted above) explicitly states that the realisation of a financial collateral arrangement may not be subject to any additional time period elapsing³⁴. This provision also blocks the application of a “freeze period” under national law³⁵.

Consequently, for example, a credit provider who has a right of pledge in respect of financial collateral, or who wants to enforce close-out netting provisions, does not have to wait until a “freeze period”, which may be applicable under na-

³⁴ This provision relates to financial collateral provided by way of a security interest, and is applied by way of analogy to financial collateral provided by way of a title transfer on the basis of Article 7 (2) of the Collateral Directive.

³⁵ Article 9 (1) of the Settlement Finality Directive is formulated in somewhat general terms, but can also be interpreted as a prohibition of freeze periods. For example the Dutch legislator has done so. See also recital 9 of this Directive.

tional law, has expired. The cash and/or securities can be released from the insolvent estate without any delay. This rule may be to the detriment of the insolvent estate, but it limits systemic risk, because recourse can be taken immediately.

4. Who pays the price for the new regime? Reasons to amend the Collateral Directive and the Settlement Finality Directive

The above points to a conflict between the objectives of the Settlement Finality and the Collateral Directive on the one hand, and reaching a fair balance between the interests of the different actors in the financial markets on the other. The Settlement Finality Directive and the Collateral Directive have the honourable goals of reducing systemic risk, finality of payments, improving the liquidity of the cash and securities markets, flexible techniques for providing and enforcing collateral, and legal certainty. At the same time, the Directives in their current form disturb the balance that is traditionally struck between the interests of collateral providers, their creditors, and collateral takers, and – in insolvency – between the different creditors of the insolvent estate.

The Collateral Directive infringes in many respects upon core principles of security interests, such as a right of pledge or a fiduciary transfer of title. A security interest combined with a “right of use” and an unconditioned enforcement regime are not compatible with those principles. In the case of a right of use, the collateral taker has a general right of disposal, which results in the collateral provider’s claim in respect of securities being degraded into a mere contractual claim against the collateral taker. The Collateral Directive also departs from normal enforcement mechanisms, which balance the interests of collateral providers (and their creditors) and collateral takers, and guarantee maximum proceeds. These developments in the field of property law undermine the fiduciary relationship between collateral provider and collateral taker³⁶.

In the field of insolvency law the Settlement Finality Directive and the Collateral Directive do not recognise the retroactive force of the declaration of insolvency. They allow a level of protection in respect of legal acts concluded even after the declaration of insolvency, and put possibly applicable “freeze periods” out of action. These latter developments are favourable to the insolvent party’s counterpart in a system or under a financial collateral arrangement, and to the detriment of all other creditors of the insolvent estate.

In the case of transactions between major credit providers (notably banks) and small- and medium-sized enterprises as the takers of credit in exchange for collateral in particular, the new rules in the field of property and insolvency law will lead to a major shift in the balance of power between the parties to the benefit of collateral takers. Collateral takers, to whom collateral has been transferred or pledged under a financial collateral agreement, are in a much stronger position

³⁶ It is therefore also regrettable that a comparable approach now seems to be taken by the drafters of the UNIDROIT Convention on Harmonised Substantive Rules regarding Intermediated Securities.

than they were before the introduction of the new regime. The costs of the new regime are carried entirely by the providers of collateral.

The next section investigates whether the goals of limiting systemic risk and improving liquidity can be reconciled with the interests of the different actors in the financial markets in a more balanced manner, by amending the Collateral Directive and Settlement Finality Directive.

III. How to change the Collateral Directive and the Settlement Finality Directive

1. Introduction

In order to limit systemic risk and to achieve the macro-economic goal of liquid markets for cash and securities, the European legislator demands the harmonisation of a number of provisions of property and insolvency law. The most important consequences of the Collateral Directive and the Settlement Finality Directive for property and insolvency law have been outlined in section II above. Generally, these changes are favourable to credit providers/collateral takers and are to the detriment of collateral providers. The European legislator's approach has particularly negative consequences for weaker parties such as small- and medium-sized enterprises. One wonders whether the macro-economic goals relating to systemic risk and liquidity could not have been attained by adopting another means of harmonizing provisions of property and insolvency law. This section will investigate how the negative consequences of the changes to property and insolvency law can be mitigated, and how the balance between the different actors involved can be restored. To this end, concrete proposals will be made for amendments to the Collateral Directive and the Settlement Finality Directive.

2. Limitation to major market participants

The first proposed change is to limit the Collateral Directive to major players on the financial markets. These major market participants are listed in Article 1 (2) (a)–(d) of the Collateral Directive. The clauses mention, for example, commercial and central banks, insurance and investment companies, and other major participants in the financial markets. These are indeed the key entities for the liquidity of the cash and securities markets. The enterprises mentioned in Article 1 (2) (e) of the Collateral Directive, including small- and medium-sized enterprises, have no or only a far more limited impact on the liquidity of these markets. Moreover, applying the Collateral Directive to situations where the collateral taker is by definition more powerful than the collateral provider is undesirable. In this case, the collateral taker can dictate the terms of the collateral agreement (e.g. whether a right of use is granted, and how enforcement takes place in the event of default). For these reasons the Collateral Directive should not apply to small- and medium-sized enterprises. These enterprises can be excluded from the scope

of applicability of the Directive on the basis of Article 1 (3) of the Collateral Directive. It should be noted that in the original proposal for a Collateral Directive small- and medium-sized enterprises did not feature at all – and rightly so³⁷.

In practice, only a limited number of Member States has applied the opt-out offered by Article 1 (3) of the Collateral Directive³⁸. On the basis of this provision, enterprises – including small- and medium-sized ones – can be excluded from the scope of legislation implementing the Collateral Directive. One of the main arguments put forward against the exclusion of transactions with enterprises on one national market is that this exclusion may lead to such transactions taking place in another Member State that has opted for a wide scope of market participants. In the course of implementation in Germany, banks presented this argument in favour of a wide scope of applicability for the Collateral Directive³⁹. The Dutch government also suggested the possibility of concluding transactions under the laws of a country other than the Netherlands as an argument to opt for a broad scope of application that would include small- and medium-sized enterprises⁴⁰.

Rather than exclude all enterprises on the basis of Article 1 (3) of the Collateral Directive, another, more moderate solution would be to exclude only the most vulnerable small- and medium-sized enterprises. In this scenario only large enterprises, which are in a position of power equal to that of financial institutions, would fall within the scope of the Collateral Directive. A practical argument against this solution, however, is that it may be difficult to formulate unequivocal criteria on a European level for enterprises to fulfil in order to fall within the scope of the Collateral Directive.

3. Abolition or amendment of the right of use

The European legislator's introduction of a device combining a security interest with a right of use is unfortunate. It is not compatible with traditional principles of pledge law and is to the detriment of collateral providers. It blurs the traditional distinction between a security interest and an outright transfer. To support the liquidity of the markets, the European legislator should have confined itself to

³⁷ See Article 2 (4) of the Proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements, issued by the Commission of the European Communities in Brussels on 27 March 2001, COM(2001) 168 final.

³⁸ It appears that only Austria, France, Germany, Malta, and Sweden have done so in one way or another. For more background information, see for example *Johansson*, (2005) 16 (5) EBLR, section 3.3; the March 2005 Clifford Chance client briefing on the "Implementation of the EU Collateral Directive"; *Klaus Löber*, The German Implementation of the EC Directive on Financial Collateral Arrangements, (2005) 20 (2) JIBLR 72–78; the report of the debate on the implementation of the Collateral Directive in the Dutch Upper Chamber of Parliament on 1 March 2005, in: *Eerste Kamer*, 2005/17, in particular p. 770; the Dutch government's Explanatory Comments (*Memorie van Toelichting*) to the Lower Chamber of Parliament, in: *Tweede Kamer*, 2004–2005, 30138, no. 3, p. 5. For a general overview of the state of implementation of the Collateral Directive in the different Member States see the International Swaps and Derivatives Association website (www.isda.org; Committees/Collateral/Collateral Law Reform Group).

³⁹ See for example the 12 February 2004 press release from the German Ministry of Justice concerning the "Neuregelung für Finanzsicherheiten".

⁴⁰ See for example the Dutch government's Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*) to the Upper Chamber of Parliament, in: *Eerste Kamer*, 2004–2005, 28874, E, section 1.

sanctioning the European market standard of the provision of financial collateral by way of an outright transfer. It would be best if the right of use were removed from the Collateral Directive.

Alternatively, the following two amendments can be made to the Collateral Directive in order to make the consequences of the right of use more acceptable. The first is to amend the terminology used. Instead of speaking of a "right of use" it would be better to use the term "general right of disposal" in the Collateral Directive. This terminology would make the consequences of the device clearer. In addition, the rule of proprietary substitution set out in Article 5(3) of the Collateral Directive needs to be revised. This rule should not be limited to equivalent assets transferred by the collateral taker at the moment that he deems fit, but should relate to any replacing assets (e.g. sale proceeds). Proprietary substitution should take place immediately at the moment that these replacing assets become part of the collateral taker's estate. These assets should not be commingled with the collateral taker's own assets, but be kept separate. Such an amendment would prevent a collateral provider from being left with a mere contractual claim towards the collateral taker.

4. No enforceability of legal acts after the declaration of insolvency

A third issue worthy of reconsideration are the provisions in the Settlement Finality Directive and the Collateral Directive, which open up the possibility of enforcing legal acts entered into after the declaration of insolvency. The European legislator has not made it sufficiently clear that there are good grounds to set aside the fixation and *pari passu* principles, and to put individual counterparts of an insolvent entity in a system or under a financial collateral agreement in an advantageous position to the detriment of all other creditors. It should be taken into account that the rule of the Directives can be abused by an insolvent entity to put favoured creditors in an advantageous position.

5. No changes required: Retroactive force of the insolvency declaration, "freeze period"

There is no need to change the insolvency rules set out in the Settlement Finality Directive and the Collateral Directive relating to the "zero hour rule" and the "freeze period". The abolition of the "zero hour rule" does justice to the principle that insolvency should take effect as of the moment it is declared by a judge. The non-applicability of the "freeze period" can be justified in the case of transactions between major financial market participants, because application of a "freeze period" would hamper the liquidity of the financial markets, and increase systemic risk.

IV. Conclusion

In order to guarantee liquid cash and securities markets in the European Union and to limit systemic risk, the Settlement Finality Directive and the Collateral

Directive set out uniform legal regimes for the settlement of payments of cash and securities, and for financial collateral arrangements. In particular they harmonise a number of issues of property and insolvency law.

In the field of property law the Collateral Directive envisages the device of a security interest combined with a "right of use", i.e. a collateral taker's general right of disposal in respect of the encumbered assets. This device leaves the collateral provider with merely a contractual claim and can content-wise be equated to an outright transfer. Besides, the Collateral Directive envisages a liberal enforcement regime in respect of security interests, such as a right of pledge or a fiduciary ownership right. Customarily applied, mandatory formalities guaranteeing maximum proceeds, such as a public sale of encumbered assets or the intervention of an objective intermediary, are rendered inapplicable. The Directive also envisages the non-applicability of the prohibition of appropriation. These changes in the field of property law are in all cases favourable to credit providers/collateral takers and to the detriment of collateral providers. Particularly in the case of collateral providers who do not enjoy an equal position of power when compared with major financial institutions, such as small- and medium-sized enterprises, this may lead to undesirable results. It is therefore also regrettable that those responsible for drafting a UNIDROIT Convention on Harmonised Substantive Rules regarding Intermediated Securities are currently considering a similar approach.

In the field of insolvency law, the Settlement Finality Directive and the Collateral Directive abolish the retroactive force of the insolvency declaration, make it possible to enforce legal acts that have been carried out after the declaration of insolvency, and prohibit the application of a "freeze period". These rules are favourable to individual counterparts of the insolvent entity in a system or under a collateral arrangement, and to the detriment of the joint creditors of the insolvent estate.

A number of changes can be made to the Collateral Directive and the Settlement Finality Directive, which honour the goal of improved liquidity and limit systemic risk, and which at the same time restore the balance between the different actors in the financial markets. Firstly, the Collateral Directive should apply only to major participants in the financial markets. Secondly, it would be best to repeal the device of a security interest combined with a general right of disposal. Alternatively, the terminology used ("general right of disposal" instead of "right of use") and the rule of proprietary substitution connected with this device should be revised. A third issue that deserves reconsideration is the rule of the Collateral Directive and the Settlement Finality Directive, which makes it possible to enforce legal acts that have been entered into after the declaration of insolvency, because this rule thwarts the fixation and *pari passu* principles and may be abused. There is no need to revise the rules of the Settlement Finality Directive and the Collateral Directive, which abolish the retroactive force of the declaration of insolvency and render "freeze periods" inoperable.