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UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES

INFORMAL WORKING GROUP ON ARTICLE 14 OF THE DRAFT CONVENTION

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Informal Working Group on Article 14 of the draft Convention

Comments on the questionnaire concerning acquisition by an innocent person

(submitted by the Finnish delegation)

The Finnish delegation would like to make the following comments on the questionnaire:

(a) On the situation of your national law

1. Special provision. *Does your legal system have a special rule on "innocent/good faith acquisition" for book entry securities?*

Yes. In Finland, the Act on Book-Entry Accounts (827/1991) provides rules on good faith acquisitions (Section 26 and 27).

1.b *If the answer is yes,*

(i) What is the standard of care chosen, a general clause (e.g., "reasonable commercial standards") or a more rigorous one (e.g. collusion, actual knowledge, wilful blindness, gross negligence, etc.)?

The person acquiring securities is regarded to be "in good faith" or "*bona fides*" unless he "knew or should have known". This condition is traditionally used and not specified by the legislator but left to be interpreted by courts and legal literature.

In general, when considering whether the party "should have known", account is taken what a normal and reasonable person would know or do, but also what could be expected from the person in question with his/her experience and knowledge. The degree of knowledge/care that is required in a particular case is also dependent on the circumstances of the transaction and the nature of the object. Not only deliberate or intentional action but also negligence can amount to *mala fides*. Yet, the party has no duty to make active investigations since entries made in the securities accounts can be relied upon.

(ii) What are the situations contemplated by the special rule (protection vis-à-vis an adverse claim, protection vis-à-vis a defective entry, etc.)?

The Act on Book-Entry Accounts provides two provisions on good faith acquisitions. Section 26 covers e.g. double transfers, i.e. cases where securities are transferred or pledged to two different persons, whereas Section 27 deals with onward transfer of securities.

According to Section 26, an acquisition of or a right pertaining to securities registered in the securities account has priority over an acquisition or a right not registered. With respect to mutually conflicting interests, the right first registered has, as a main rule, priority over the right registered later. However, the right registered first does not prevail, if at the time of the acquisition that person knew or should have known of the earlier acquisition. In other words, registration of an acquisition or a right does not give priority to a person in *mala fides*.

According to Section 27, the rights of the transferee are not affected by the fact that the transferor did not have the right to dispose of the securities, except if the transferee, at the time of the acquisition, knew or should have known thereof.

(iii) Does it contain a special provision for organisations? If so, please describe.

No.

2. Case law. *In your country or abroad, are you aware of any real cases in which the "good-faith/innocent acquirer clause" has been applied in relation to intermediated securities? If so, please summarise (if possible).*

No.

3. Other issues. *Please comment on any other point or issue that, in relation to your national law, you consider relevant for the purpose of this paper.*

There are not only terminological but also material differences between Sections 26 and 27 of the Act on Book-Entry Securities and the provisions of the draft Convention.

First, both Sections 26 and 27 are generally applicable to all dispositions of securities, i.e. transfer of ownership, pledge etc. So, unlike the draft Convention, no distinction is made on the basis of the fact whether the disposition is made by a credit or designating entry. Moreover, even though the main rule under Section 26 is based on the first in time principle, i.e. the right first registered has priority, an exception is made if the person is not innocent/*bona fides*. This rule applies not only to dispositions made by credit but also to designating entries (pledges). Second, when considering whether or not the person is innocent/*bona fides*, negligence can be taken into account. The test in the draft Convention seems therefore easier to fulfil. Third, the timing in Sections 26 and 27 is based on *bona fides* evaluation at the time of the acquisition (not time of the perfection). Finally, Sections 26 and 27 are also applicable to gifts.

In Finland, the burden of proof lies with the person who claims that another person is in *mala fides*/not innocent. This is due to a thinking that *mala fides* is easier to prove than *bona fides*. We note that Article 14 does not deal with questions of burden of proof at all. Even though such procedural issues were to be regarded as falling outside of the scope of the draft Convention, we think burden of proof is a relevant question when considering the formulation of standard of care.

(b) On Article 14 of the Convention

4. Article 14: current text

4.a *Do you agree with the description of Article 14 of the Draft Convention made in this paper (supra para. nº 2)? If not, please elaborate your answer.*

4.b *Leaving aside the standard of care issue, do you have any problems with the current text of that provision, e.g.:*

(i) as to the differences between the situations described in paragraph 1 and 2, including the reference to article 10 and the special provisions of SSS and account agreements (which are referred to in the second paragraph but not in the first paragraph)

It is not very clear what kinds of situations paragraph 1 and 2 are meant to cover in general and what is the difference between these paragraphs. In our understanding, paragraph 1 provides a general rule that would be applied for example in double transfer situations. As to paragraph 2, it is our recollection, that it covers so called onward transfers and "defective entry" was introduced for drafting purposes only (see Doc. 58).

As to the question, which types of interests are covered by paragraph 1 and 2, we note that interests under Article 10 (e.g. designating entry) are merely taken into account in the scope of paragraph 2. Thus, paragraph 1 does not cover a dispute between two holders of interests under Article 10 since this should be solved by Article 15 on priority only. As explained above, our current legal system is different in this respect.

The purpose of and the need for the reference to rules of the settlement system and account agreements in paragraph 5 is not very clear. It is to be noted that Article 13.2 on invalidity and reversals is subject to Article 14, which in our interpretation gives priority to innocent acquisitions. Consequently, we wonder whether Article 14.5 introduces a possibility for the rules of the settlement system to worsen the protection of innocent acquisitions - or is the purpose to permit those rules to improve the protection?

(ii) the definition of "defective entry"

(iii) the special rule for organisations

We wonder if the temporal condition in paragraph 4 (c) is clear and workable.

(iv) the relationship of Article 14 with other provisions of the Convention, etc.?

See above (i) with respect to Article 13 and 15.

In addition, it is not clear whether insolvency related issues are in the scope of Article 14. The first question is if an insolvency estate/administrator can be regarded as another person having an interest in intermediated securities in the meaning of the provision. If the answer is affirmative, a transferee would be protected if he is innocent as regards the opening of insolvency proceedings against the transferor.

Second question is the relationship of Article 14 with Article 18 (effects of insolvency), in particular whether Article 18 permits insolvency rules of automatic avoidance of transactions to be used even though the rights of the innocent person under Article 14 otherwise bind the insolvency administrator. This question is partly dependent on the scope and purpose of Article 18 (whether or

not it permits such automatic avoidance rules), which is subject to another Working Group. Nevertheless, we would like to raise this question in this context.

5. Standard of care: theoretical approaches

5.a *Do you agree with the description of the possible approaches to the "innocent/good faith acquirer issue" made in this paper (supra para. nº 5-6)? Can you think of other solutions? If so, please describe them.*

5.b *Do you agree with the summary of the pros and cons of each approach made in this paper? Can you think of other arguments? If so, please describe them.*

5.c *In particular, which approach do you consider more adequate to the world of electronic book-entries? Which one do you consider more neutral and functional?*

We believe the draft Convention should provide a provision that protects innocent acquisitions. This enhances legal certainty and promotes liquidity of intermediated securities.

A harmonised rule at a global level would be the best possible result, but we think a solution based on minimum harmonisation ("safe harbour") would be easier to agree upon and would seem to provide sufficient protection. In this alternative the draft Convention would require that acquisitions that fulfil minimum conditions are protected as innocent acquisitions. Contracting States would be able to provide more favourable provisions for innocent persons, at least with respect to questions like the scope of cases where the protection is possible and the point of time at which innocence is required.

As regards the standard of care, we would prefer wording that would be as general as possible since detailed tests might prove to be difficult to apply. Rules should also be flexible enough so that they could be applied in various circumstances.

We also note that current Article 14 is based on a test of knowledge or wilful blindness in which negligence is not sufficient. Our current legal situation is different in this respect since negligence (not slight however) can amount to *mala fides*. We understand that liquidity of intermediated securities might justify a test where mere slight negligence does not fulfil the conditions of *mala fides*, but still we doubt that the current test of "wilful blindness" is too lenient, i.e. it protects persons that are "*mala fides*" in normal sense. The test should therefore be adjusted to some extent. Yet, if the test of knowledge were included in the "safe harbour" solution put forward above, the degree of care could be set at a minimum level which all Contracting States should ensure, but it would allow Contracting States to give more favourable rules for innocent persons if they so wished. Article 14 could, therefore, provide that a person is disqualified for the protection also in cases of (gross) negligence – letting those Contracting States that would like to give more favourable rules stipulate that only knowledge or wilful blindness could lead to disqualification.

5.d *Are you aware of international instruments that, on the acquisition of assets, contain a rule for innocent/bona fide purchaser?*