



**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

Response to the questionnaire concerning acquisition by an innocent person

(submitted by the delegation of the United Kingdom)

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

1.1 English law does not have special rules for the purchase of book-entry securities save in the case of securities that are settled in CREST, the settlement system for UK listed securities.

1.2 A purchaser of securities that is a participant in CREST can rely upon Regulation 35(4) of the Uncertificated Securities Regulations 2001 as a defence against adverse claims other than in circumstances where it has *actual* notice that the settlement in CREST was made without the authority of the previous owner of the securities.

1.3 Accordingly, in the case of uncertificated securities in CREST, the legal owner will be bound by a ‘properly authenticated dematerialised instruction’ sent from its computerised link with CREST without its consent if the purchaser had no actual knowledge of this lack of authority.

1.a Does the traditional “good faith clause” apply?

1.4 Where the transfer of book-entry securities takes effect outside CREST and the Uncertificated Securities Regulations 2001, the purchaser is reliant upon the equitable principle of a good faith purchaser of legal title without notice (see 2 below). This principle applies generally to transfers of property under English law to defeat adverse equitable claims. As explained in 4 below, there is some doubt whether the general principle applies to purchases of intermediated securities across the books of an intermediary.

1.5 English law recognises the principle of good faith purchaser. A good faith purchaser must acquire the legal title to the securities and act in good faith. It must demonstrate that it gave sufficient value for the property as nominal consideration is not sufficient. A good faith purchaser must also have had no notice of equitable interests at the time when it gave value for the property

and when it was transferred to him. There is conflicting authority as to whether the burden is on the defendant to demonstrate that it gave value and had no notice or on the plaintiff to show that the test is not satisfied. A number of academics have written in favour of the authorities that impose the burden on the defendant.

1.b Standard of Care: Test of Notice

1.6 Under Section 199 of the Law of Property Act 1925 a purchaser is not prejudicially affected by notice of any instrument, matter, fact or thing, unless it has:

(1) *actual notice*: where the equitable interest is within his own notice;

(2) *constructive notice*: where the equitable interest would have come to his own knowledge if he had made proper inquiries; and

(3) *imputed notice*: where his agent has actual or constructive notice of the equitable interest in the course of the same transaction.

1.7 Under the Law of Property Act 1925, a purchaser has constructive notice of matters that would have come to his knowledge if such inquiries had been made as ought reasonably to have been made by him.

Constructive notice in commercial transactions

1.8 The law has developed a significant distinction in relation to constructive notice between transactions involving land and other transactions. For property other than land, the purchaser is under no duty to make inquiries as to title in the absence of suspicious circumstances since “the courts are most reluctant to import a duty of inquiry as to title which would restrict the flow of commerce.”

1.9 Thus, the Court of Appeal in *Polly Peck (No 2)* held that, in the context of commercial transactions not involving land, a purchaser will not have constructive notice unless suspicious circumstances existed but he deliberately or recklessly failed to make the inquiries that an honest and reasonable man would have made.

2. Case law on good faith purchase of intermediated securities

2.1 The application of the doctrine of constructive notice to securities transactions was considered in *Macmillan Inc. v Bishopsgate Trust (No 3)*.¹ At first instance, Millet J cited Lord Browne-Wilkinson’s formulation of the doctrine of constructive notice in *Barclays Bank plc v O’Brien*² as being of general application. In that case Lord Browne-Wilkinson said:

...if the party asserting that he takes free of the earlier rights of another knows of certain facts which put him on inquiry as to the possible existence of the rights of that other and he fails to make such inquiry or take such steps as are reasonable to verify whether such earlier right does or does not exist, he will have constructive notice of the earlier right and take subject to it.³

¹ [1995] 1 WLR 978.

² [1994] 1 AC 180.

³ [1994] 1 AC 180 at pp 195-196.

2.2 The test requires a purchaser under English law to investigate if it has knowledge of facts putting it on inquiry. In the absence of such facts there would appear to be no duty to investigate. In this respect English law is consistent with the Convention. However, according to *O'Brien* facts need only give rise to the *possible* existence of an earlier right rather than a *significant probability* in the case of the Convention test. Furthermore, once put on notice, the decision in *O'Brien* requires the purchaser to take such steps as are reasonable to verify whereas under the Convention the purchaser need do nothing provided it does not deliberately avoid information that would establish that the existence of an adverse claim.

2.3 The application of the constructive notice test laid down in *O'Brien* has since been limited by the House of Lords decision in *Royal Bank of Scotland v Etridge (No 2)* to a narrow class of cases involving suretyship.⁴ Accordingly, there is no clear case-law authority upon which a court would rely in establishing the test of constructive notice for book-entry securities.

2.4 The UK Law Commission has speculated that the English courts would take a narrower view of constructive notice than that established in *O'Brien* when applying it to the settlement of securities across the books of a financial intermediary. That said, while this narrower view may bring it closer to the test currently formulated in the Convention, the Law Commission has acknowledged that removing any obligation to investigate suspicious facts and attributing constructive notice only to purchasers that deliberately avoid information is probably a step beyond where the English courts have reached to date.

3. Other issues

Uncertainty as to the availability of the good faith purchaser defence for intermediated securities

3.1 The good faith purchaser rule under English law protects a person who in good faith acquires legal title without notice of any prior equitable interests in the property.

3.2 Under English law, intermediaries typically hold securities for their clients by way of an express trust. A trust involves the separation of legal and equitable title. Accordingly, if an intermediary holds title to the securities directly from the issuer on trust for its client, it follows that the client's interest in the underlying securities will be equitable in nature. If, as may often be the case, the securities are held through a chain of intermediaries, the highest tier intermediary will hold the legal title to the underlying securities with the intermediary directly below it holding an equitable interest in them. The conclusion generally drawn from this analysis is that each lower tier intermediary will hold its equitable interest as sub-trustee on sub-trust for the intermediary below it and so on down to the investor at the bottom of the chain. Consequently, the bundle of rights and interests held by the investor (and by each lower tier intermediary) represent *equitable* rights and interests that are derived through a series of sub-trusts from the underlying securities.

3.3 As intermediated securities are equitable in nature, the transfer of indirectly held securities made by way of a credit and debit on the books of an intermediary will necessarily constitute a disposition of an equitable interest. No *legal* title in relation to an acquisition of intermediated securities will pass unless the underlying securities are also delivered to, or re-registered in the name of, the purchaser (or an intermediary through whom the purchaser holds its investment).

⁴ See also Chitty on Contracts (29th ed) 7-096.

3.4 Accordingly, unless a purchaser of intermediated securities separately acquires some *legal* right or advantage (and not simply an *equitable* right), there is a degree of uncertainty as to whether a court would find that the good faith purchaser rule applies. If it did not apply, the law would instead determine the competing equitable claims of the vested interest and the purchaser in accordance with equitable priority rules. The general equitable rule states that priority goes to the claimant with the better equity. Where the equities are otherwise equal, the first in time prevails and therefore the original owner takes precedence over the subsequent purchaser.

3.5 Incorporating the UNIDROIT Convention (as currently drafted) into English law would remove this uncertainty by granting purchasers of intermediated securities a level of protection that closely matches that of purchasers of directly held securities under English law.

4. On Article 14 of the Convention

4.a Do you agree with the description of Article 14 of the draft Convention? Yes.

4.b Do you have any problems with the current text of the provision?

4.1 We would like to point out two related issues of uncertainty that do not appear to have been addressed by the current formulation of the innocent purchaser test or by the proposed alternatives.

Uncertainty as to meaning of an 'organisation'

4.2 Understandably, the level of knowledge necessary to prevent an account holder from relying on the Convention defence is the same whether the account holder is an individual or an organisation. If the account holder is an organisation, the question arises as to the appropriate point in time at which the organisation should be treated as being aware of a fact. The Convention states that in the case of organisations, knowledge is attributed to it "from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant". The time of knowledge is important in determining the availability of the defence as an organisation or individual can still rely on the defence if it only became aware of the fact or interest after the time that the securities are credited.

4.3 The formulation of this rule for an organisation raises two connected issues. The first concerns the meaning of the term 'organisation'. The lack of a definition in the Convention makes it unclear how widely the term should be construed. For example, should it cover organisations that are not corporate entities or which lack legal personality (such as partnerships)? In addition, should the term cover separate legal entities within a corporate group?

4.4. The need for a clear and consistent approach to attributing knowledge to an organisation is desirable as it is commonplace in the securities industry for large institutions to operate from a single location, in relation to the global activity of numerous subsidiaries acting as nominees. Even if the nominee subsidiaries into whose accounts the securities are credited have employees or active managements they are quite likely to have no knowledge of the underlying transaction and of any potential violation of a third party's claim. However, fairness suggests that where relevant knowledge is obtained by the legal entity within the group managing a trade, it ought reasonably to be attributed to the nominee account holder within the corporate group in whose name the securities are credited.

Lack of a concept of imputed knowledge

4.5 In addition to, or instead of, widening the meaning of organisation to include more than one legal entity, the Convention should at the very least recognise the possibility of imputing the knowledge of certain specified categories of person to the account holder (see below). These categories could include not only affiliates of the account holder but also agents acting on its behalf.

4.6 The Convention currently makes no provision for imputing knowledge to a purchaser. We accept that the various exceptions and nuances to the concept of imputed knowledge may mean that it is necessary to make any Convention rule on imputed knowledge subject to domestic law. Nevertheless, we are concerned that if the possibility of imputing knowledge is not recognised by the Convention the innocent purchaser defence could be manipulated through the use of an agent or by other corporate structuring to give a defence to purchasers where none should exist.

4.7 By way of example, where a fund management company arranges for the purchase of securities to be made by a related nominee subsidiary despite knowing of an adverse claim, the purchase could be protected from the adverse claim under the current Convention test on the grounds that the nominee subsidiary, as purchaser, had no knowledge of the claim. While the claimant may have a personal claim against the fund management company it will have no means of recovering the securities which may be crucial if the fund management company is insolvent.

5. *Standard of care: theoretical approaches.*

Do you agree with the description of the possible approaches to the “innocent purchaser/good faith acquirer issue”? Can you think of other solutions?

We agree that the approaches set out in the Working Paper represent the most likely alternative solutions.

A harmonised test would be most beneficial in removing uncertainty in the settlement of securities, but we acknowledge that it is difficult to establish a uniform test that is sufficiently clear without requiring a significant change to the legal concepts employed by some legal systems. If the test was made wide enough to accommodate fundamental differences between legal systems, the effect could be counter-productive, particularly, if the clarity in existing national legislation was replaced with a test that was vague and too open to inconsistent interpretation. In those circumstances, we consider an “opt-out solution” to represent a more pragmatic and neutral solution. We do not consider the purely “national solution” to be an appropriate option as we can see no benefit in removing altogether the ability for Contracting States to adopt an innocent purchaser test that is shared by a potentially substantial number of other national systems.