The Security Interest Provisions of the UNIDROIT Convention on Intermediated Securities

Michel Deschamps *

The purpose of the *UNIDROIT Convention on Substantive Rules for Intermediated Securities* (hereinafter: the *Convention*) is to establish a common legal framework for the holding and disposition of intermediated securities.[1] Intermediated securities are securities held with an intermediary; they are often referred to as indirectly held securities, although that term is not used in the *Convention*.[2] A simple case of intermediated securities is the following: ABC, a publicly traded company, has issued shares; the registered holder of the shares in the ABC's books is a central securities depository; a securities broker has an account with the depository in which ABC shares are held; an investor has a securities account with the broker in which ABC shares are held. The investor is then considered to hold intermediated securities.[3]

Conceptually, secured transactions law may be divided into four main issues: the creation of a security interest as between the parties, the effectiveness of the security interest against third parties, its priority rank and the enforcement of the remedies arising from the security interest. The *Convention* leaves the creation issue to "non-Convention law" and focuses on the other three issues. The term "non-Convention law" refers to the applicable law in a Contracting State, other than the provisions of the *Convention*.[4]

* Partner, *McCarthy Tétrault LLP* (Canada); Lecturer, Law Faculty of the University of Montreal. The author participated in the elaboration of the *Convention* as one of the Canadian delegates and also participates in law reform projects in the area of secured transactions sponsored by UNIDROIT and the United Nations Commission on International Trade Law (UNCITRAL).

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1 See the Preamble to the *Convention*.

2 The drafters of the *Convention* have attempted to avoid characterizing the legal nature of intermediated securities, recognizing that under some legal systems securities held in a securities account may be considered as "directly held", at least for certain purposes.

3 In this fact pattern, the broker also holds intermediated securities as a result of shares of ABC being credited to its account with the depository.

4 Art. 1(m).

It should be noted that the *Convention* deals only with the substantive rules on the three issues in question. Conflicts of laws are left to non-Convention law. Accordingly, a Contracting State will apply the *Convention* only if its conflict-of-laws rules designate the law of that State (or of another Contracting State) as the applicable law on the matters dealt with in the *Convention*. The *Convention* might, however, have to be applied in a non-Contracting State if the conflict rules of that State (being then the forum State) point to the law of a Contracting State as being the applicable substantive law.

As mentioned above, the rights of the investor with respect to the ABC shares credited to its account are called "intermediated securities". In some legal systems, such as those of the United States and Canada, intermediated securities are called securities entitlements. The *Convention* aims at providing basic legal rules on the acquisition and disposition of intermediated securities, including the acquisition of a security interest in them.[5]

This paper will examine the main provisions of the *Convention* on the following issues:

- the effectiveness against third parties[6] of a security interest in intermediated securities;
- the priority of the security interest as against competing claimants; and
- the enforcement of the remedies of the secured creditor.

For the sake of convenience, the term "grantor" will be used to refer to a person who grants a security interest and the term "secured creditor" will be used to refer to a person holding a security interest; the term "encumbered securities" will be used to describe intermediated securities subject to a security interest. A competing claimant is a third party who might claim an entitlement to the encumbered securities; competing claimants therefore include other creditors of the grantor (including secured creditors) and an insolvency administrator in insolvency proceedings relating to the grantor.

I. – EFFECTIVENESS AGAINST THIRD PARTIES

Under the *Convention*, a security interest in intermediated securities may be made effective against third parties in two ways: if the securities are held in a

5 The *Convention* uses the term "security interest", not the term "security right" employed by the *UNCITRAL Legislative Guide on Secured Transactions*.

6 "Perfection", in the terminology of some legal systems.

securities account in the name of the secured creditor [7] or if the secured creditor obtains control of the securities.[8] The *Convention* also contemplates that other methods may be provided by the non-Convention law to render a security interest effective against third parties.[9]

1. Securities held by the secured creditor

The *Convention* provides that the credit of securities to a securities account is sufficient to make the acquisition effective against third parties and that no further step is required to achieve such effectiveness. The term "acquisition" is not defined but includes the acquisition of a security interest. Accordingly, a security interest in intermediated securities is effective against third parties by the mere fact that the securities are held in a securities account of which the secured creditor is the account holder.

This rule prevails over any provision of the non-Convention law which would otherwise prescribe formalities (*e.g.* a notarial deed or a registration) for the security interest to be effective against third parties.[10]

2. Control of the securities by the secured creditor

The *Convention* envisages three other instances where a security interest may become effective against third parties. In these instances, the encumbered securities remain in the account of the grantor but the secured creditor directly or indirectly obtains control of them. For any of these instances to apply, a Contracting State must, however, make a declaration to that effect.[11]

The first possibility is where an account holder grants to its intermediary a security interest in some or all of the securities credited to its account.[12] In such a case, the security interest of the intermediary is treated as being automatically effective against third parties. The rationale for this rule is that the intermediary, being the person who maintains the account, is in a position

[7] Art. 11.

[8] Art. 12.

[9] Art. 13.

[10] As previously mentioned, the *Convention* does not specifically deal with the "creation" of a security interest in intermediated securities but Art. 11 may be construed as implying that nothing more than an agreement (even oral) between the grantor and the secured creditor is required to create the security interest.

[11] Art. 12(1)(b).

[12] Art. 12(3)(a).

to control or block any attempted disposition of the encumbered securities by the account holder.

The second possibility is where an agreement is entered into between the account holder, the intermediary and the secured creditor whereby the latter becomes empowered to prevent a disposition of the encumbered securities by the account holder or to dispose of them without any further consent of the account holder;[13] the *Convention* describes such an agreement as a "control agreement".

The third possibility is where an entry is made in favour of the secured creditor in the securities account of the grantor which has the same effect as a control agreement.[14] Indeed, the account holder must agree to the making of the entry and the non-Convention law or the account agreement must provide that the entry will have the intended effect. Such an entry is referred to in the *Convention* as a "designating entry".

3. Other methods of achieving third-party effectiveness

The *Convention* does not preclude a State that ratifies the *Convention* from providing, in its secured transactions regime, for other methods for making a security interest in intermediated securities effective against third parties.[15] The methods contemplated by the *Convention* serve the same function as possession does for a security interest in tangible property; most legal systems recognize that a security interest in tangible property is effective against third parties where the property is held by the secured creditor (or by another person acting on behalf of the secured creditor).

Legal systems that recognize non-possessory security interests often subject their third-party effectiveness to registration of the security agreement (or of its potential existence) in a public registry. Thus, the *Convention* allows a Contracting State to provide that a security interest in intermediated securities may also become effective against third parties by registration (or by any other method not specified in the *Convention*).

II. – PRIORITY RULES

One might consider that a security interest, once made effective against third parties, would necessarily have priority over another interest which has not

13 Art. 12(3)(c).

14 Art. 12(3)(b).

15 Art. 13.

yet become so effective. However, for policy reasons, many legal systems contain priority rules among competing claimants which are not always based on priority being given to the person who is the first in time to achieve third-party effectiveness. The *Convention* adopts the same approach and determines the priority of a security interest in accordance with the following hierarchy:

- A secured creditor to whose account the encumbered securities are credited prevails over any competing claimant (the "First Level Rule").
- A secured creditor who has obtained control of encumbered securities remaining in the account of the grantor has priority over another person claiming an interest in such securities (the "Second Level Rule").
- A secured creditor relying only on the non-Convention law will have such priority as may be afforded by the non-Convention law but will always rank after a secured creditor whose priority ranking is recognized by the *Convention* (the "Third Level Rule").

The above rules will resolve a priority dispute in a scenario where several persons claim an interest granted by or arising from dealings with the same grantor (a horizontal priority dispute); this is the typical scenario addressed by secured transactions law. The *Convention* also envisages other scenarios where a competing claimant asserts an interest not deriving from the grantor; these other scenarios may give rise to a dispute commonly referred to as a vertical priority dispute. An example of a vertical dispute is the case where the intermediary maintaining the account in which encumbered securities are held has granted to another person a security interest which could impair the rights of the secured creditor.

1. Horizontal priority disputes

(a) The First Level Rule

Under this rule, if encumbered securities are held by the secured creditor in a securities account in its name, the security interest will prevail over the rights of any other person claiming directly or indirectly an interest in the encumbered securities, including another secured creditor.

This rule is not designed specifically for security interests and rather results from the provisions of the *Convention* for the protection of an innocent acquirer of intermediated securities. A person to whose account securities are

credited acquires its interest in such securities free from any interest that may be claimed by another person.[16] The rule is, however, subject to the acquirer not being aware that the credit "violates the rights of that other person".

The following example illustrates the application of the rule in a horizontal priority dispute: suppose that A grants to B a security interest in securities credited to a securities account held by A with an intermediary and that an agreement is entered into between the intermediary, A and B, whereby the latter obtains control of the encumbered securities; subsequently, A grants a security interest in the same securities in favour of C and, in spite of the control agreement, the intermediary accepts to transfer the securities to a securities account maintained by it in the name of C. To the extent that C is in good faith,[17] C's security interest will prevail over B's security interest.

Three observations must be made with respect to this result.

Firstly, the example shows that the First Level Rule gives priority to the "last in time to perfect" and not to the "first in time to perfect". Another way to describe the First Level Rule is to characterise it as conferring a super-priority on a person who acquires an interest in securities by the credit of same to a securities account held by that person: the good faith acquirer takes the securities free from pre-existing interests in these securities.

Secondly, the priority conferred on C, as account holder, does not mean that the intermediary is released from the contractual obligations incurred by the intermediary in favour of B under the control agreement. Indeed, B would normally have recourse against the intermediary for the loss that B might sustain as a result of the intermediary having transferred the securities to C's account in violation of the control agreement.

Thirdly, from a conceptual standpoint, the First Level Rule might be analysed as a rule *not* dealing with competing claims over the *same* securities (even if the competing claims – as in the example – arise from dealings with the same grantor): the *Convention* treats the credit of securities to a securities account as creating *new* intermediated securities.[18] Accordingly, in the example, as a result of the credit to its securities account, C has acquired intermediated securities which are not the same as those previously held in A's securities account. Therefore, the First Level Rule might be better described as a shelter which protects an account holder from third party

16 Art. 18.

17 The term "good faith" is used here as shorthand to describe the requirements set out in Art. 18 that have to be met for C being entitled to protection.

18 Arts. 9 and 11.

claims irrespective of the legal foundation of these claims (e.g. claim of a property interest, tracing rules, claim for damages, etc. ...).

(b) The Second Level Rule

In many circumstances, it would be impractical or inconsistent with the purpose of the transaction to transfer the encumbered securities to an account of the secured creditor. In the case where the parties intend that the encumbered securities remain in a securities account of the grantor, obtaining control of the securities is the best method by which the secured creditor may achieve third-party effectiveness. The secured creditor would then have priority over any competing claimant with an interest in the same securities who has not obtained control.[19]

It is, however, possible that control of encumbered securities be obtained by more than one person; this will be the case if a person grants a security interest in the same securities to two different creditors and if a separate control agreement is concluded with each secured creditor. In such case, priority will be given to the secured creditor whose control agreement is first in time.[20]

There is, however, an exception to the rule that among secured creditors who all have control, the order of priority is based on the time when control was obtained. As previously mentioned, an intermediary who benefits from a security interest in securities in an account maintained by it automatically has control.[21] If, subsequent to the grant of the security interest in its favour, the intermediary consents to control of the securities account being given to a third party, the third party's interest will prevail over the intermediary's security interest.[22] It would in effect be illogical that an intermediary consent to control being conferred on another secured creditor but at the same time retain a prior ranking security interest in the securities controlled by the secured creditor.

(c) The Third Level Rule

The lowest level of priority is assigned to secured creditors who only rely on non-Convention law to achieve third-party effectiveness. They will rank after any secured creditor who benefits from the First Level Rule or the Second

19 Art. 19(2).

20 Art. 19(3).

21 Art. 12(3)(a).

22 Art. 19(4).

Level Rule.[23] The *Convention* is silent on the rank of these claimants among themselves and therefore leaves the matter to the law outside the *Convention*.

2. Vertical priority disputes

A number of vertical priority disputes may arise and they will be resolved by the provisions of the *Convention* on the protection of an innocent acquirer [24] whenever these provisions apply. The *Convention* also has a specific vertical priority rule on interests granted by intermediaries.[25] This rule is an application to intermediaries of the innocent acquirer provisions and its operation may be used to illustrate how a vertical dispute may occur.

Suppose that account holder A grants to B a security interest in 1000 shares of X credited to A's account with intermediary C; suppose also that A, B and C enter into a control agreement conferring on B the control of the account; suppose in addition that the 1000 shares credited by C to A's account have been obtained by C through a credit of equivalent shares in an account held by C with D, another intermediary. If C grants to D a security interest in the 1000 shares of X credited to C's account with D, D's security interest will prevail over any claim that A or secured creditor B might make with respect to the 1000 shares of X held in C's account with D. To be protected against adverse claims by A or B, D must, however, be in good faith, that is to say, D must be unaware that the security interest granted by C might violate the rights of A or B. In the context of secured transactions, the practical implication of the rule is that, in the event of the insolvency of an intermediary, the rights of a secured creditor of an investor may be defeated by a secured creditor of the intermediary who maintains the investor's account if the intermediary's secured creditor has obtained control (which is always the case if the intermediary's secured creditor is another intermediary).

III. – ENFORCEMENT OF REMEDIES

Upon a grantor being in default to perform the obligations secured by a security interest, most legal systems will permit the secured creditor to enforce its security interest through judicial proceedings. In a context where the encumbered assets consist of securities, the time constraints and the number of steps inherent in judicial proceedings may result in a lesser realization

23 Arts. 18(1) and 19(2).

24 Art. 18.

25 Art. 20(2).

value for the secured creditor if, for instance, the market value of the securities is decreasing. Some legal systems provide that a secured creditor may also realize on a security interest without judicial intervention or authorization, in particular where the encumbered assets consist of securities traded on an organized market. The *Convention* adopts that approach.

Essentially, the *Convention*'s provisions on enforcement allow the secured creditor, if the debtor is in default, to dispose of the intermediated securities without any prior notice or court supervision requirement.[26] Moreover, the *Convention* provides that the commencement of insolvency proceedings against the debtor may not stay the enforcement rights of the secured creditor.

The *Convention*'s provisions on enforcement are, however, optional and intended to supplement non-Convention law. It should also be noted that the *Convention* recognizes a title transfer agreement for security purposes as a distinct legal institution; accordingly, the exercise of the contractual rights provided in such a transfer would not be subject to the legal regime applicable to security interests.[27]

26 Art. 33.
27 Art. 32.