

Priority Rules

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I. Introduction.

A comparison between different legal systems provides a way of making sure that it is in fact identical situations that are compared. This is especially true with respect to priorities as the many systems may in fact reach same result in an identical fact pattern, but may nevertheless use different legal reasoning to get to this result. Consequently, to make sure a valid comparison is made a functional approach must be taken. The basis of the functional approach used in this paper is outlined in part II by way of exemplifying the most common priority disputes that may arise. In this paper, a priority dispute is to be understood in the broadest sense thus including any conflict regarding rights in securities between parties that do not have any contractual relationship. E.g. a conflict between an account holder and the creditors of the account provider is considered a priority dispute, as there is no contract between the account holder and the creditors of the account provider. Further, as a result of the functional approach, the focus is to merely determine who “wins” in a particular conflict. Consequently, words like “priority over”, “has a right against” and “can enforce his right against” are used interchangeably (and are not meant to rely on any national distinction between priority, effects on third parties or enforceability). E.g. in this paper to say that A has a right enforceable against B is the same as to say that A has priority over B.

In part III the rules of the different member states are compared to discover if they are actually differences. Such differences may result in legal uncertainty and transaction costs.

In part IV an attempt is made to formulate some general principles (rules) for solution of priority conflicts regarding intermediated securities. In relation to each of these principles it is discussed to what extent the principles based on the comparison in Part III are already followed by the member states and to what extent an adoption of the principle is necessary to avoid legal uncertainty and transactions cost. The purpose of this analysis is to facilitate discussion in the Legal Certainty Group about the need and content of a possible future EU (or global) regulation.

II. The different priority disputes.

II.1. Explanation to graphic illustrations.

In part II the following abbreviations are used:

Account holder (A)

Account provider (I)

Transferee (T): Meaning a person who by *contract* acquired a right from an account holder or an account provider. If the transfer is made by way of transfer of the securities to the transferees account, the transferee is also an account holder and is thus named TA. If this is not the case, e.g. because the transfer is pledge in the securities still held at the transferors account, the transferee is simply named T.

Creditor or creditors (C): Any creditor action whether individual (e.g. an attachment from a judgement creditor) or collective as in the case of insolvency proceedings.

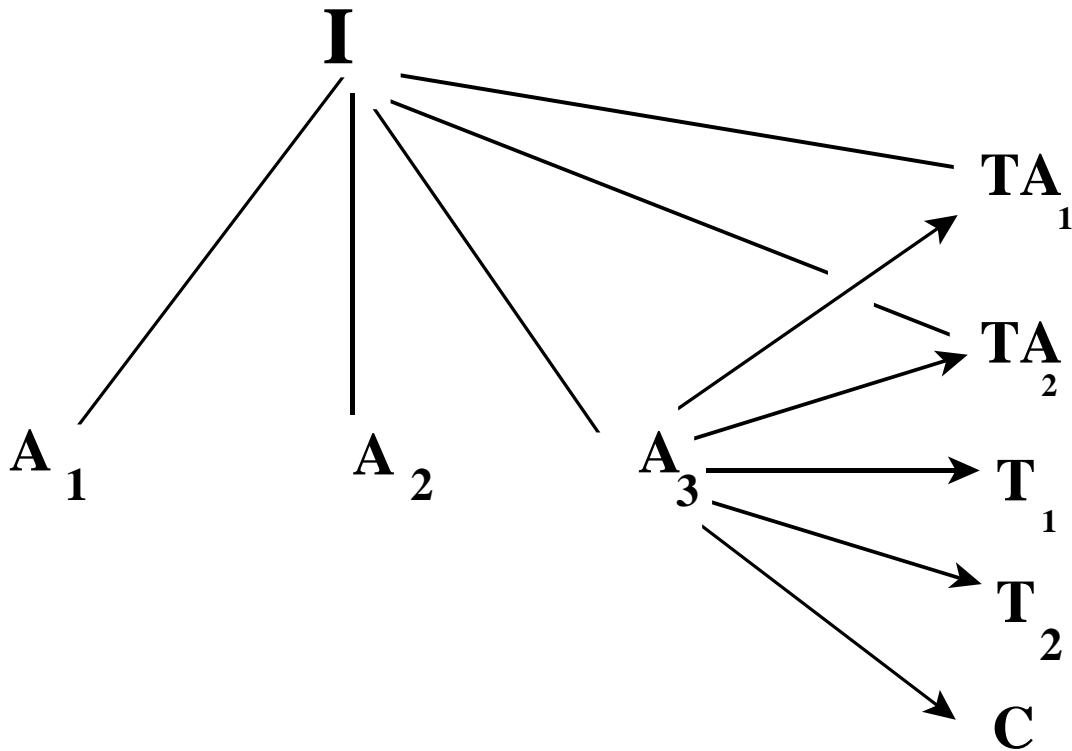
“—“ illustrates an account relationship (between an account holder and his account provider)

“→“ illustrates a transfer or creditor action.

For every conflict one or more possible solutions are listed. Of course, it is not an exhaustive list of possible solutions, but merely an indication of the perhaps most likely ones.

II.2. Scenarios including only one account provider.

Graphic illustration:



(The illustration does not presuppose that rights were created in a specific order, e.g. T₁'s right may (or may not) have been created before the right of TA₁).

Different priority conflicts in Scenario II.2:

Conflict no. 1 (A₁-A₂-A₃): The conflict between the account holders (A₁, A₂ and A₃) of I.

Such conflicts are most likely to arise in case of insolvency of the account provider and only if there is a shortfall of securities (this shortfall may be a result of an infringement of public law by the account provider). Possible solutions: Pro rata sharing (perhaps limited to apply to the kind of securities that the account provider is short of), first-in-time has priority (last-in-time account holder loses) or last-in-time has priority (first-in-time account holder loses).

Conflict no. 2 (A1-T1): The conflict between an account holder (A1) and a transferee (T1) who contracted with another account holder (A3).

In this example T1 who contracted with A3 does not get the securities transferred to his own account. The scenario does not presuppose any kind of contractual relation between A1 and A3/T1 and thus merely addresses the issue of whether T1 in case of shortfall is entitled to a share of the remaining securities. Possible solution: T1 has same position as A1 against A3 has (in case of shortfall). T1 so to speak steps in A3's shoes.

Conflict no. 3 (A1-TA1): The conflict between an account holder (A1) and a transferee (TA1) who contracted with another account holder (A3) and got the securities transferred to his own account.

In this example TA1 does get the securities transferred to his own account with I. As if conflict no. 2 no contractual relation between A1 and the transferee (TA1) is presupposed. Possible solution: TA1 is considered an independent account holder of I, provided the transfer from A3 to TA1 was valid under contract law. The "usual" shortfall rules (conflict no. 1) apply to the relation between A1 and TA1.

Conflict no. 4 (A1-C): The conflict between an account holder (A1) and the creditors (C) of another account holder (A3).

The fact pattern is identical with the one in conflict no.2 except that A3 instead of granting a pledge is subject to a creditor action. Possible solution: C has same position as A1 against A3 has (in case of shortfall). C so to speak steps in A3's shoes.

Conflict no. 5 (T1-T2-TA1-TA2): The conflict between two transferees of the same account holder (A3).

This example may be divided into 3-subexamples (as it may make a difference whether the transferee is a TA or merely a T):

No. 5 a): T1-T2. Possible solutions: First in time has priority provided he perfected his interest.

No. 5 b): TA1-TA2. Possible solutions: Both acquire status of independent account holders of I (creating a shortfall) or first-in-time has priority (based on an assumption that the last-in-time right cannot be valid if the first-in-time right has not validly ceased to exist).

No. 5 c): T1-TA1. Possible solutions: TA1 wins (provided good faith) as he got the securities transferred to his own account or T1 wins if first-in-time (provided T1 perfected his interest before the transfer to TA1).

Conflict no. 6 (T1/TA1-C): The conflict between a transferee and the creditors of the same account holder (A3).

This example may be divided into 2-subexamples:

No. 6 a): T1-C. Possible solutions: First in-time has priority provided the right first-in-time was perfected.

No. 6 b): TA1-C. Possible solutions: First in-time has priority provided the right first-in-time was perfected or TA1 wins (even if second-in-time) as he got the securities transferred to his own account (probably provided good faith re C's interest).

Conflict no. 7 (I-T1/TA1): The conflict between the account provider (I) and a transferee of an account holder (A3). This example may be divided into 2-subexamples:

No. 7 a): I-T1. Possible solutions: T1 has the same position against I as A3 (T1's right is merely derived from A3's right) and T1 thus have no right against I if e.g. A3's right against I was invalid (e.g. because the credit to A3's account was an error). Another possible solution is that T1 (provided good faith) acquires a right against I independent of A3's right (in other words that T1's right is not dependent of A3 himself having a valid right against I). The latter solution is probably only possible if I somehow confirms directly to T1 that T1's right has been registered, noted or otherwise accepted by I. A related problem is whether T1 can enforce his right directly against I (e.g. if T1 is a pledgee and A3 defaults). Even if T1 has a right against I (either derivative or independent of A3), the question of what documentation T1 must deliver to I to prove that A3 was in default under the terms of the secured loan. One solution is to require that T1 obtains a judgement against A3 if A3 contests that he has defaulted. Such solution does not rule out that T1 and A3 agree in the pledge agreement that T1 has authority towards I to realize the collateral on A3's account (without having to verify to I that A3 defaulted). Such an agreement would not deprive A3 from claiming damages from T1 if T1 sells the collateral despite lack of default from A3. Another solution could be to say that T1 even without such an

agreement has the right to realize the collateral without proving to I that A3 has defaulted (again without depriving A3 from claiming damages from T1 in case of unjustified realization).

No. 7 b): I-TA1. Possible solutions: TA1 (provided good faith) acquires a right against I independent of A3's right due to the fact that I opens an account in the name of TA1. Another solution could be that TA1 even if acting in good faith merely acquires a right against I to the extent A3 had a valid right against I (TA1's right is considered merely derived from A3).

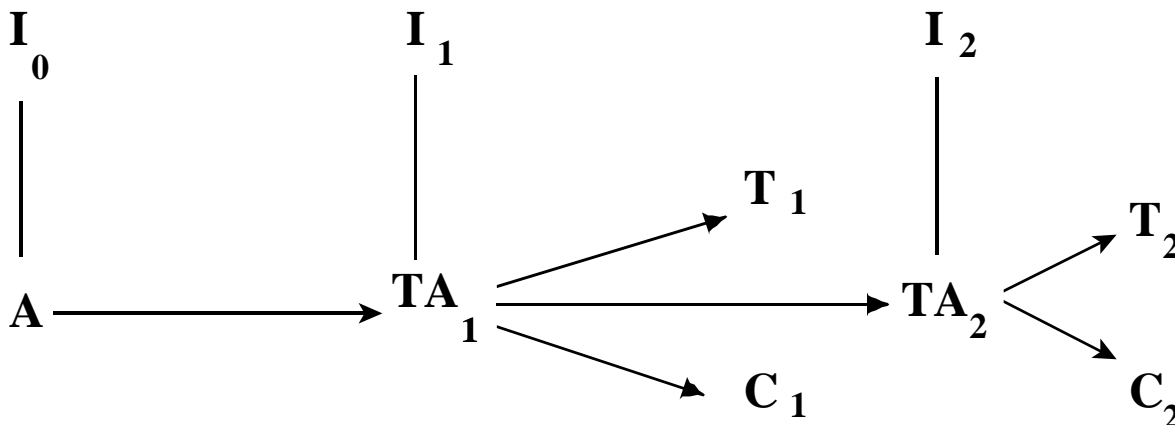
Conflict no. 8 (I-C): The conflict between the account provider (I) and the creditors (C) of an account holder (A3).

Possible solution: C has same position as A3 has against I. C so to speak merely steps in A3's shoes.

Conflicts between an account holder and his account provider are not priority conflicts as the parties have a contractual relationship. Conflicts between an account holder (A3) and his transferees (T1, T2, TA1 and TA2) or creditors (C) are not priority disputes either, as these conflicts also are contractual or based on a previous direct creditor-debtor relationship.

II.3. Scenarios including side-tier intermediaries.

Graphic illustration:



(The illustration does not presuppose that rights were created in a specific order except that the transfer from A to TA1 necessarily has to take place before a transfer from TA1 to TA2/T1 and a transfer from TA2 to T2)

Different priority conflicts in Scenario II.3:

Conflict no. 9 (A-II): The conflict between an account holder (A) and the account provider (II) of a transferee (TA1) who acquired a right from A.

In practice, the question is whether A in case the transfer to TA1 is voidable under contract law (due to fraud, non-payment etc.) can reclaim securities directly from II (this could be named “side-tier-attachment”). Possible solutions: A has no right against II as II is not A’s account provider but instead TA1’s. Consequently, A has only a claim against TA1 and cannot enforce directly against II. Another possible solution is that A is entitled to demand that II returns securities to A (and consequently debits TA1’s account at II). This solution probably requires that A has a judgement establishing his claim against TA1 (otherwise II cannot know if A’s claim is justified) and that TA1 has securities of the kind demanded on his account with II at the time when A demand II to return securities. A variation of this latter solution is to say that a judgement obtained by A against TA1 is equal to a consent from TA1 to the return of securities and that this consent may be used by A directly against II, so that II on the basis of the judgement is obliged to return securities to A (to the

extent such securities are available on TA1's account) without the need for further confirmation by TA1.

Conflict no. 10 (A-T1/TA2): The conflict between an account holder (A) and a transferee (T1 or TA2) who acquired a right from TA1 (who acquired a right from A).

The conflict presupposes that A has some just reason to challenge the initial transfer to TA1 (typically voidability under contract law e.g. as a result of fraud). The example may be divided into two sub-examples based on whether the subsequent transferee (T1 or TA2) was acting in good faith or not.

No. 10 a), transferee acting in good faith. Possible solutions: A cannot challenge the subsequent transfer to T1/TA2 (good faith acquisition rule). Probably, it does not matter whether the conflict is with TA2, who received a transfer to his own account (with I2), or the conflict is with T1 who e.g. received a pledge in TA1's account and perfected that pledge in good faith. However, in the latter situation it might be argued as an alternative solution that T1 and A should share pro rata as they are both innocent parties claiming securities from the same account (such a solution would make it difficult for T1 to access his position before lending to TA1 as he does not know of A's interest). Finally, as an alternative to a good faith acquisition rule it might be considered a solution generally to let A prevail based on argument that no subsequent right (T1 or TA2) can be validly created as long as A's right did not validly cease under the contract with TA1 (however such solution would put good faith transferees in a very difficult position).

No. 10 b), transferee not acting in good faith. Possible solutions: If the subsequent transferee was not acting in good faith (knew about the fraud committed by TA1 against A), it might matter whether the subsequent transferee is a T1 or a TA2. T1 probably loses against A, if T1 was not acting in good faith. TA2, on the other hand, may have priority over A due to the fact that it is not possible to trace A's interest to TA2's account as e.g. the securities acquired from TA1 may have been commingled on TA2's account with securities of the same kind (this does not rule out that A under tort law may be able to claim damages from TA2 based on the fact that TA2 acquired securities in bad faith). Another solution is to maintain that A has priority in TA2's

account (even if tracing is not possible) as it is sufficient to establish that some of the securities on TA2's account was credited to the account as a result of TA2 acquiring from TA1 who acquired from A (transaction tracing instead of tracing of individual securities).

Conflict no. 11 (A-C1): The conflict between an account holder (A) and the creditors (C1) of a transferee (TA1) who acquired a right from A.

Possible solutions: C1 has the same position as TA1 has against A. As the transfer from A to TA1 was void, A has priority over C1. Another solution would be to say that A only has priority over C1 if A can trace his securities, which e.g. would not be case if the securities that TA1 acquired from A was commingled on TA1's account with other securities of the same kind.

Conflict no. 12 (A-I2): The conflict between an account holder (A) and an account provider (I2) who maintains an account for a transferee (TA2) who acquired a right from TA1 (who acquired a right from A).

It is only necessary to discuss if A has any right against I2, if it is presupposed that A has a right (priority) against TA2 (see answer to conflict no. 10). Possible solution: If TA2 was not acting in good faith and A as a consequence is held to have a right in TA2's account (see answer to question 10 b), A probably is able to exercise his right against I2 (TA2's account provider) to the same extent as A could exercise right against I1 (the account provider of TA1). In other words the same solution as to conflict no. 9.

Conflict no. 13 (A-T2): The conflict between an account holder (A) and a transferee (T2) who acquired a right from TA2 (who acquired a right from TA1 who acquired a right from A).

It is only necessary to discuss if A has any right against T2, if it is presupposed that A has a right (priority) against TA2 (see answer to conflict no. 10). Possible solution: T2 wins against A if T2 was acting in good faith (about A's right); as an alternative it might be argued that A and T2 should share pro rata (similar alternative solution as to conflict no. 10 a). If T2 was not acting in good faith, A has the same right (priority) against T2 as he has against TA2.

Conflict no. 14 (A-C2): The conflict between an account holder (A) and the creditors (C2) of a transferee (TA2) who acquired a right from TA1 (who acquired a right from A).

It is only necessary to discuss if A has any right against T2, if it is presupposed that A has a right (priority) against TA2 (see answer to conflict no. 10). Possible solution: C2 has the same position as TA2 has against A. Consequently, if it assumed that A has priority against TA2, A also has priority over C2.

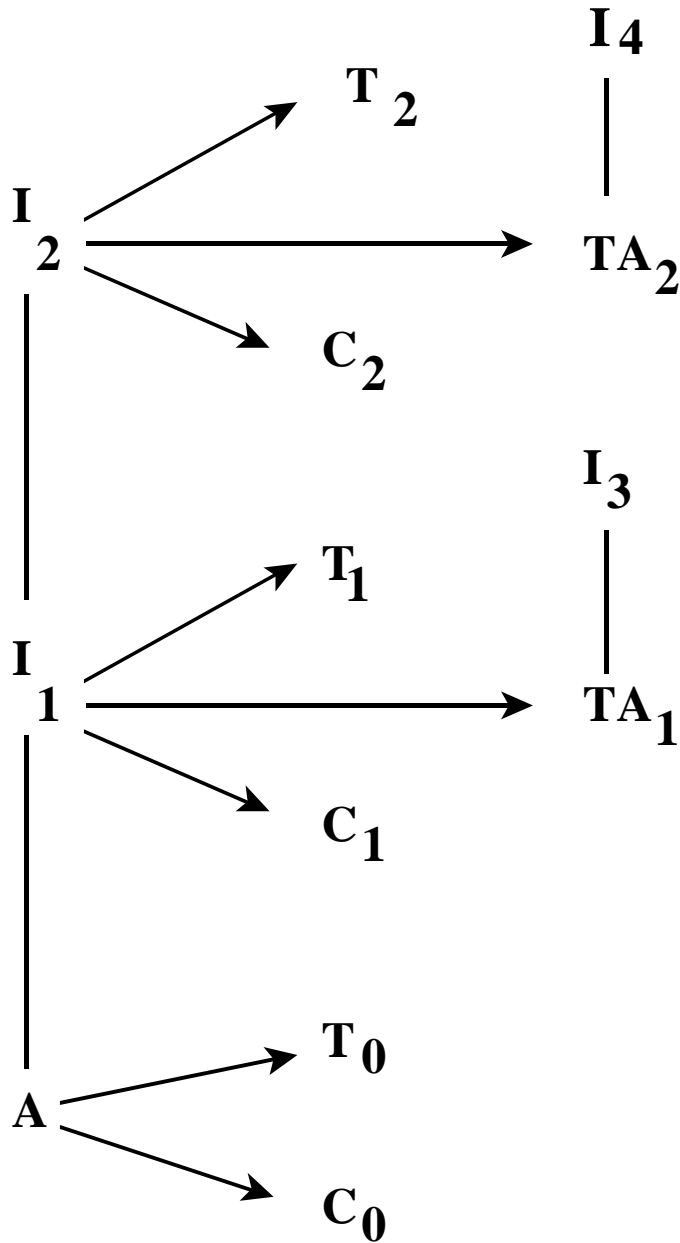
Conflict no. 15 (T1-T2): The conflict between a transferee (T1) acquiring from another transferee (TA1) and a transferee (T2) acquiring from a different transferee (TA2).

There is no true conflict between T1 and T2, as their respective rights concern different accounts (TA1's and TA2's account, respectively). In other words, the fact pattern rather consists of two conflicts: The conflict between T1 and I1 (does T1 have a right against I1 irrespective that TA1 have no right against I1) and the conflict between T2 and I2 (does T2 has a right against I2 even if TA2 did not acquire his rights in good faith about A's right). These conflicts are similar to conflict no. 7 a) and thus do not represent new conflicts.

The conflicts between T1, C1 and TA2 are similar to the conflicts in Scenario II.2 between T1, C and TA1 and thus do not represent new conflicts.

II.4. Scenarios including upper-tier intermediaries.

Graphic illustration:



(The illustration does not presuppose that rights were created in a specific order, except that A's account with I1 and I1's account with I2 are assumed to have been opened before any transfer or creditor action).

Different priority conflicts in Scenario II.4:

Conflict no. 16 (A-TA1/T1): The conflict between an account holder (A) and a transferee who acquired his right from A's account provider (I1).

The conflict is only likely to arise in case of insolvency of I1 as I1 of course is obliged towards both A and TA1/T1. The example may be divided into 2-subexamples:

No. 16 a): A-TA1. Possible solution: TA1 gets the securities transferred to his own account and obtains priority over A (this may create a shortfall if I1 does not hold sufficient securities to meet all account holder claims, see conflict no. 1). The fact that TA1 knows that I1 transferred from an omnibus account should probably not in itself constitute lack of good faith as TA1 should generally be able to assume that I1 is entitled to dispose over an account (the omnibus account) held by I1.

No. 16 b): A-T1. Possible solutions: T1 (e.g. a person having a pledge in the omnibus account) gets priority over A, as T1 should not be in a worse position than a TA1 as that would have the consequence that a lender must choose an outright transfer (to be a TA1) rather than a pledge (to be a T1) to eliminate the risk of claims from account holders like A. An alternative solution would be to rank T1 and A equal (pro rata sharing) based on an argument that both are innocent parties claiming against the omnibus account (a solution that however would have the effect of putting a T1 in a worse position than a TA1).

Conflict no. 17 (A-I3): The conflict between an account holder (A) and an account provider (I3) who maintains an account for a transferee (TA1) who acquired his right from A's account provider (I1).

Possible solution: If the solution to conflict no. 16 is that TA1 provided good faith has priority over A, the conflict will only arise if TA1 is not acting in good faith because he positively knew that I1 made the transfer in fraud of A. If A in such a situation has priority over TA1, the question of whether A can enforce his right against I3 (TA1's account provider) must be addressed the same way as conflict no. 9. Consequently, conflict no. 17 in fact does not represent a new conflict.

Conflict no. 18 (A-C1): The conflict between an account holder (A) and the creditors (C1) of A's account provider (I1).

Possible solutions: C1 has the same position as I1 against I1's account holders. Consequently, A has priority over C1. It might be argued that if the omnibus account contains a surplus (more securities than A and the other account holders claim for), this surplus represents I1's own securities which have been commingled with the account holders securities, and that A (and the other account holders) consequently cannot trace their rights to a specific part of the omnibus account and thus have no priority over C1. In the opposite situation, where there is a shortfall, it might also be argued that tracing is not possible (as it is not known which account holders securities are missing). However, in the shortfall situation it may alternatively be argued that the account holders are not only entitled to the remaining securities on the omnibus account but also takes priority over C1 with respect to securities that I1 holds on non-customer accounts as those securities must in fact be considered belonging to the account holders, based on the assumption that I1 cannot say to have any securities of its own if there is a shortfall and the fact that some of the securities are wrongfully kept on I1's "own" account does not change that.

Conflict no. 19 (A-I2): The conflict between an account holder (A) and an upper-tier-account provider (I2).

Possible solution: Generally, A has no rights against other intermediaries than his own account provider (I1). Consequently, A cannot enforce his rights against I2. However, it may be argued that if I1 wrongfully rejects to follow instructions from A, A should be able to enforce his right directly against I2 provided e.g. that A has obtained a court order evidencing that I1 wrongfully denied to follow instructions from A. A variation of this solution is to say that such a court order against I1 is equal to an instruction of I1 to I2 and that this "court ordered instruction" may be used by A directly against I2, so that I2 on the basis of the court order is obliged to transfer securities to an account specified by A (to the extent such securities are available on I1's account with I2) without the need for further confirmation by I1. The fact pattern has some similarities with conflict no. 9.

Conflict no. 20 (A-T2/TA2): The conflict between an account holder (A) and a transferee who acquired his right from an upper-tier account provider (I2).

Possible solution: To assume that A can assert any right against a transferee acquiring from I2 must require that I1 (as account holder of I2) could enforce its rights against the transferee acquiring from

I2. However, as stated re conflict no. 16 the likely answer is that an account holder cannot assert rights against a transferee acquiring from the account holders account provider. Consequently, as I1 cannot enforce any right against the transferee acquiring from I2 neither can A. A different (and contractual) issue is whether A's right against I1 remains unaffected despite I2's disposition, see conflict no. 21.

Conflict no. 21 (A-C2): The conflict between an account holder (A) and the creditors (C2) of an upper-tier account provider (I2).

Possible solution: To assume that A can assert any right against the creditors of I2 must require that I1 (as account holder of I2) could enforce its rights against the creditors of I2 (see conflict no. 17). However, if I1 has priority against the creditors of I2, there is no reason that A should be able to assert his right individually (as I1 by exercising its right ensures the position of A).

Related contractual issue: Even if I1 has priority over C2, it may be that I1 suffers a loss if there is a shortfall of securities (as I2 may have disposed over the securities held for I1 and others, cf. conflict no. 20) and I2 due to insolvency may be unable to cure the shortfall. In such a situation it can be discussed if I1's loss affects the right of A towards I1 or not (whether I1 is entitled to pass on the loss to A and I1's other account holders). In principle, this is a contractual issue between A and I1, but as it is closely related to priority conflicts no. 20-21, it may be appropriate at least to have a non-mandatory uniform (contractual) rule on the issue.

Conflict no. 22 (A-I4): The conflict between an account holder (A) and an account provider (I4) who maintains an account for a transferee (TA2) who acquired his right from an upper-tier account provider (I2).

Possible solution: As A does not have any right against TA2 (cf. conflict no. 20), A cannot enforce any right against I4 (TA2's account provider).

Conflict no. 23 (T0-C1): The conflict between a transferee (T0) who acquired his right from an account holder (A) and the creditors (C1) of A's account provider (I1).

Possible solution: T0 derives its right from A and should consequently at least have the same position against C1 as A has. Further, T0 only has a right in A's account with I1 and consequently cannot be entitled to a better position against I1 or I1's creditors (C1) than A. The

contract between A and T0 must be decisive as to whether A or T0 is entitled to enforce their “joint” rights against C1 (cf. conflict no. 7).

Conflict no. 24 (T0-T1): The conflict between a transferee (T0) who acquired his right from an account holder (A) and a transferee (T1) who acquired his right from A’s account provider (I1).

Possible solution: T0 must at least be entitled to the same priority against T1 as A has against T1. However, as T1 is likely to have priority over A, cf. conflict no. 16, the question is whether T0 is entitled to a better priority against T1 than A. The likely solution is that T0 should not be afforded such better priority as T0’s right is merely in A’s account (with I1), whereas T1’s right is in I1’s (omnibus) account (with I2). The arguments in favor of giving T1 priority over A (and other account holders of I1) similarly lead to giving T1 priority over any interest created by A.

Part III. Comparison of the solutions of each priority conflict under the laws of the member states based on the questionnaire.

Conflict 1: A1-A2-A3

This conflict describes competing claims of the account holders A1, A2 and A3 of the insolvent account provider I which is subject to an obligation to remedy a shortfall.

Question 15 of the Questionnaire outlines the protection of the investor in case of insolvency of the account provider I. Question 31 of the Questionnaire expressly refers to a shortfall with respect to an account provider and the difference in treatment of shortfalls when such account provider is insolvent compared to cases where he is not; however, it does not expressly cover the scenario of insolvency of the account provider which has caused a shortfall.

Therefore, most rapporteurs did not provide a concise answer to exactly determine the treatment of conflict 1 between the competing account holders A1, A2 and A3.

On the basis of the answers given in Q 15, 29, 30 and 31 addressing the conflict 1, the conflict among the competing account holders is assumingly resolved in a way that no account holders wins over the other but all loose to the same (proportionate) extent.

Reasons:

The overwhelming majority of answers state that the securities booked in an account with an insolvent account provider I are considered to be the ownership of the investor or third party and are thus unavailable for the creditors of the insolvent account provider I. Therefore, these securities remain available for the account-holders in the mere event of insolvency of the account provider I; a conflict would thus not exist.

However, where (i) a shortfall has been caused by the account provider I and (ii) the account provider I has fallen insolvent thereafter, most countries would oblige the insolvent account provider

I to cure the shortfall by way of a buy-in of securities covering the shortfall or by compensation in money to the account holders A1, A2 and A3. Thus, mostly the account holders would win proportionately provided such obligation is satisfied.

Only in very exceptional circumstances, the answers to Q 29-31 expressly indicate that such claim is, and to which extent, affected by the insolvency of the account provider I. In these cases the claims of the account holders can not be satisfied.¹ Consequently, in such cases all account holders loose except where a lower tier account provider is liable for the higher tier insolvent account provider.²

Moreover, the extent of loss resulting from such non-satisfaction is not clearly specified. It is assumed that the loss would be applied proportionately to the holding of account holders at the time the shortfall has occurred (as this would match with the loss sharing principles applicable when there is no fault of the account provider I for the shortfall and principles of insolvency of law of equal treatment of creditors not having preferred rights); in exceptional cases, an insolvency court would determine the treatment of the shortfall.³ No principle is recognized that the account-holder holding the securities subject to the shortfall for the longest time (first-in-time) wins over the other holding the securities for a shorter time.

However, in most cases no definitive answer is given as to whether the claim of the account holders against the account provider I is effected by the insolvency of the account provider. The assumption, however, is that answer must be given in the affirmative.

Conflict 2: A1 – T1

In addition to the facts of Conflict 1, T1 has received a pledge from A3.

None of answers to the Questionnaire reviewed indicate clearly if A1 or T1 wins. As an assumption, A 1 and T1 will loose pro rata, which with respect to T1, the portion of securities attributable to A3.

Conflict 3: A1-TA1

In addition to the facts of Conflicts 1, TA1 has received the securities from A3 by way of an outright transfer of title. Neither party win over the other, A1 and TA1 loose pro rata as described in Conflict 1.

Conflict 4: A1-C

Conflict 4 describes the insolvency of the account provider I and the account holder A3 resulting in a conflict between A1 and C (creditor of A3). In the main, the answers to Question 15 dictate that the insolvency of account provider I leaves unaffected the rights to the securities of all account holders of I, including A1 and A3.⁴ The effects of the insolvency of A3 on the rights of either A1 and C is out of scope on the answers to the Q 23-25 and 29-31. However, whether A1 or C wins might

¹ Q 29: United Kingdom, p 333; Q 31, Ireland, p 340

² Q 31, Germany, p 338

³ Q 30: Sweden, p 337

⁴ Martin Thomas in the horizontal analysis to Q 15 wrote: “In the main, where the AP plays no role in establishing property rights, its insolvency is irrelevant to those rights and accordingly the investor needs no protection against the AP’s insolvency. Where the AP does play a role in establishing property rights, the position seems to vary according to whether the AP is a CSD.”

depend on the moment of transfer and the insulation of transfer orders of the transferor (e.g. A3) in case of such transferor's insolvency.

Conflict 5: T1-T2-TA1-TA2

Conflict 5 describes competing claims between two transferees (either T1/T2 or TA1/TA2) of the same transferor, account holder A3. In sub-example 5a, A3 pledges the same securities twice (assumably subsequently, not at the same moment of time). Sub-example 5b relates to a transfer, i.e. A3 "transfers" the same securities twice (assumably subsequently, not at the same moment of time) and the same securities are (erroneously) credited to the accounts of both transferees in the same amount. Sub-example 5c describes the situation where A3 has pledged and subsequently transferred the pledged securities to a transferee acting bona fide.

5a) In the main, answers to Q 23 do not provide a concise answer who wins. From the answers addressing a scenario such as 5a, the transferee who received the pledge first wins over the one who received the pledge thereafter.⁵

5b) The answers to Question 23-25, 29-31 do not provide a concise solution who wins. It appears that 5b) regards a case of erroneous booking of securities. Therefore, a conflict between two transferees only exists if the two bookings (which might not be a valid transfer in every case) of securities have both proprietary effects incurring rights on each of the transferees.

Whether this is the case is dependent on the nature of rights subject to the transfer with respect to book-entry securities and the question from whom the transferees derive such rights. Where the rights subject to the transfer are derived from the transferor and his entitlement to dispose, a second transfer with respect to the same securities following the first transfer (by debit of the transferor's account and debit of the transferee account) can - by definition - not occur. Where the rights acquired by a transferee are originally created in the moment of crediting the account of the transferee, a conflict might occur.

Therefore, the answers to Question 11 are relevant. A slight majority of answers state the rights of the transferee are derived from the transferor.⁶ Among some of those, the operational concept that each credit to an account is only valid if it corresponds to a debit is expressly referred to.⁷ Therefore, the first transferee having credited the securities based on the debit of the transferor's account "wins" over the other, the second transferee has not acquired any rights.

Among the answers where the rights subject to a transfer are created upon the credit in the transferee's account, no concise answer is given as to how exactly the conflict is resolved. However, the rules on erroneous credits might apply (see Conflict 8).

5c) The answers to Questions 23-25, 29-31, in particular to Question 24, do not provide a concise solution who wins. 5b describes a situation where the account holder has pledged the securities to T1 and has subsequently transferred the securities (to which he holds still the title) to TA 1. To the contrary, the answers to Question 24 describe the legal framework for a party receiving securities from a party not holding the title to transferred securities.

⁵ Q 23: France, p 279; Italy, p 281, Cyprus, p 282; Luxembourg, p 284; Sweden, p 286; United Kingdom, p 287

⁶ Q 11: CZ, p 161; Denmark, p 161; Germany, p 161; Spain, p 162; France, p 163; Ireland, p 163; Latvia, p 164; Lithuania, p 164; Hungary, p 164; Netherlands, p 165; Poland, p 165; Portugal, p 165; Slovenia, p 165; Sweden, p 166

⁷ Q29 : Germany, p 324; Cyprus, p 329; Portugal, p 331

Conflict 6 : T1/TA1 , C

Conflict 6 describes the competing claims between the creditors of the insolvent account-holder A3 and transferees T1 and TA1. In Sub-example 6a, A3 has pledged the securities, in sub-example 6 b, in sub-example 6 b, TA1 receives securities by an outright transfer, i.e. either under an ordinary transaction for sale, or under a title transfer collateral arrangement, but are in any case credited to TA1's account.

6a: T1, C

The answers do not provide any information to evaluate whether T1 or C wins. The answers to resolve conflict 6a is assumingly a matter of national insolvency law as, if applicable, amended by the Directive 2002/47/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 6 June 2002 on financial collateral arrangements which is beyond the scope of the Questionnaire.

6b: TA1, C

Provided that the account provider is not a notified system in the meaning of the Directive 98/26 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 19 May 1998 on settlement finality in payment and securities settlement systems ("SFD"), none of the answers give the necessary information to resolve the conflict: where the transfer of securities from A3 to TA1 is an outright transfer (but not for collateral purposes), national insolvency law would decide who wins which outside the scope of the Questionnaire. Where the transfer made for collateral purposes, see additionally answer to 6a.

Provided that the account provider would be a notified system, the transfer orders given by A3 for the transfer of securities to T1, and thus the transfer A3 to TA1 is subject to additional protection under the national law implementing the SFD, thus the credit on the account might not be reversed in order to protect the system. However, this does not mean that the transfer can not be voided outside the notified system which gives rise to a transfer order to revert back the securities from TA1 to the insolvency estate of A3 for recourse of the creditors, including C.

Conflict 7: I-T1/TA1

Conflict 7 describes competing claims between the account provider I and the transferee T1 or TA1. In sub-example 7a, securities credited to an account of account-holder A3 and subject to a lien of the account provider I are pledged by A3 to T1. In sub-example 7b, securities credited to the account of account provider A and subject to the lien of the account provider I are transferred to TA1 on which account the securities are then credited.

Preliminary remarks:

Question 25 refers to "*liens*" of intermediaries. The concept of lien has a common law connotation. It describes a security interest based on possession and entitles the lienee to retain possession of assets until the secured obligation is discharged; it generally does not confer a power of sale. Opposed to a lien, where possession is delivered otherwise than by way of security, for example by way of

custody, a pledge involves the delivery of possession by way of security.⁸ The pledgee is able to enforce the pledge by selling the assets.⁹

It is noted that certain answers only make reference to pledges, other answers such as the Luxembourg or Malta do neither refer to a “lien” nor to “pledge” but refer to rights of “*privileges*” of, e.g. depositories operating a securities settlement system.

General Overview:

Most answers confirm the existence of a lien of the intermediary¹⁰ with differences whether it is created contractually¹¹ or is conferred by operation of law¹², or further depending on the capacity the lienee is acting in, i.e. only as operator of securities clearing or settlement system¹³, as intermediaries other than a CSD¹⁴, as CSD and other custodians¹⁵, as a bank¹⁶; others refer to a pledge¹⁷, differentiating whether created only contractually¹⁸ or by operations of law¹⁹, others refer to a right of retention²⁰, others refer to a privilege²¹, others do not give a concise answer.²²

7a

Generally, none of the answers give any indication if I wins over T1 or vice versa. One can possibly assume that with respect to the answers referring to pledges of the account provider I, and such pledge being perfected prior to the pledge of T1, this pledge has priority over the pledge of T1 as indicated in sub-example 5a.

7b

The same applies to this sub example. Certain assumption can however be made. Where I has received a lien in the strict common law sense, or similarly, a right of retention against the debtor A3, the transfer of the securities to the account of TA1 will most likely cease the existence of the lien and thus I will lose. Where a pledge concept is used, the transfer of the securities to TA1 might effect the pledge of I depending on the possibility for TA1 to acquire title to the securities unencumbered based on the principle of good faith. Q 24 does not address the principle of good faith with respect to encumbered securities but only with respect to the lack of title of the transferor. Where I has a right of privilege, the effect of the transfer might be the same as with a lien and I will lose.

⁸ J. Benjamin, *Interest in Securities*, Chapter 5.24, p 104, Oxford, 2000

⁹ J. Benjamin, *Interest in Securities*, Chapter 5.03, p 98, Oxford, 2000

¹⁰ Q 25: Belgium, p 297; CZ, p 297, Germany, p 298 ; Estonia, p 298; Spain, p 299; Ireland, p 300, Portugal, p 304, Slovenia, p 304; United Kingdom, p 304

¹¹ Q 25: Estonia, p 298; Italy, p 301; Netherlands, p 303

¹² Q 25: Spain, p 298; Ireland, p 300, Hungary, p 303;

¹³ Q 25: Belgium, p 297

¹⁴ Q 25: CZ, p 297

¹⁵ Q 25: Germany, p 298

¹⁶ Q 25: Ireland, p 300; United Kingdom, p 304

¹⁷ Q 25: France, 300; Italy, p 301; Hungary, p 303; Poland, p 303; Finland, p 304, Portugal, p 304

¹⁸ Q 25: France, p 300; Italy, p 301 ; Netherlands, p 303 ;

¹⁹ Q 25: Poland, 303 ; Portugal, p 304

²⁰ Q 25: Spain, p 298; Netherlands, p 303;

²¹ Q 25: Luxembourg, p 302; Malta, p 303; this might also apply to Belgium albeit the rapporteur refers to “lien”

²² Q 25: Greece, p 298; Cyprus, 301; Latvia, p 302; Slovakia, p 304; Sweden, p 304;

Conflict 8: I-C:

This conflict describes the competing claims between the account provider I and the creditors of the account holder A3 where there has been an erroneous credit of securities on the account of the account provider A3 which is not reversed until the insolvency of the latter.

None of the answers of the Questionnaire deals exclusively with erroneous credits. Question 21 in that respect tries to evaluate the effects of an erroneous credit on the concept of finality.

In the main, I wins as most jurisdiction allow a reversal of erroneous credits. Differences exist whether this right of reversal by the intermediary is a right conferred upon by law²³ or can be agreed by contract²⁴ or is not otherwise characterized.²⁵

In the minority of cases, I would loose as countries do not allow for such a reversal²⁶ or do not provide for any rule on reversals of erroneous credits.²⁷

Some answers are unclear.²⁸

Conflicts 9-24 (awaiting input from assistants)

Part IV. Suggested general principles on priorities.

1. The structure of part IV.

In part II the different priority disputes having been listed through examples. In Part III it has been analyzed how the likely outcome of each priority dispute is under the law of the respective member states. In this part an attempt is made to list some general principles that are sufficient to solve the priority disputes listed in part II. Each of these general principles is related to one or more of the priority conflicts listed in part II. In other words, each general principle will – if adopted – result in a particular solution to one or more of the priority conflicts listed in part II. Footnotes are used to illustrate which of the priority conflicts listed in part II that are relevant for the general principle discussed.

In relation to each principle it is discussed on the basis of the analysis in part III whether the principle is already followed by the member states in their respective legislation and if not whether the derogation between the results reached under the current legislation of the member

²³ Q 21: Belgium, p 256; Germany, p 257; France, p 260; Cyprus, p 262; Luxembourg, p 264; Finland, p 268 requiring the consent of the beneficiary to the credit

²⁴ Q 21: CZ, p 256; Denmark, , p 257; Portugal, p 266; United Kingdom, p 269

²⁵ Q 21: Spain, p 259

²⁶ Q 21: Estonia, p 258; Greece, p 258; Italy, p 262; Slovakia, p 268;

²⁷ Q 21: Ireland, p 261; Latvia, p 263; Lithuania, p 262; Slovenia, p 267 ;

²⁸ Q 21: Hungary, p 264; Malta, p 265; Netherlands, p 265 with respect to the securities subject to the Securities Giro Administration and Transfer Act; Poland, p 266; Sweden, p 269

ought to be addressed by harmonization. It is not discussed whether such harmonization should be made at the EU level or instead through a global initiative like the UNCITRAL-project.

2. Six suggested general principles priorities.

2.1. Bona fide credit rule. Protection of a credit to an account resulting from a valid contract made in good faith.

Principle no. 1: An account holder who as a result of a contract with a transferor receives a credit to his account has priority over any right created by contract with or by creditor action against the transferor and the credit is valid against the account provider.²⁹

Principle no. 1 applies regardless of whether:

- the contract was a true sale or a transfer of ownership for security
- the credit has resulted in a corresponding debit (but overcrediting may be a criminal offense and lead to a shortfall, see exception d)).
- The transferor was himself acting as an account provider for others.

Exceptions to principle no. 1:

- a) The contract between the account holder and the transferor was invalid under contract law.
- b) The account holder knew or ought to have known at the time when the credit was made that the transferor was not entitled to transfer the securities to the account holder, e.g. because the initial credit to the transferor was made in error, was a result of voidable contract or because the transferor already had contracted to deliver or pledge the securities to another person or was subject to insolvency proceedings or that an attachment in the securities had been made by a creditor of the transferor.³⁰

²⁹ Conflict no. 3, 5 b, 5 c, 10 a, 16 a and 20.

³⁰ Conflict no. 6 b, 7 b and 10 b.

Limitation of exceptions a)- b): Even if exception a) or b) apply, the account provider is only obliged to reverse credit made in favor of the account holder to the extent stated in principle no. 6. Rules on finality may further limit the possibilities of demanding reversal to be made by the account provider (or a system).

c) The credit was explicitly made provisional and the provision is not met.

d) The account holder is subject to principle no. 3 (shortfall rule) even if some of the other account holders' right were also created by a contract with the same transferor (typically the account provider).³¹

Is an adoption of principle no. 1 necessary to avoid legal uncertainty and transaction cost?
(awaiting finalization of Part III)

2.2. Protection of account holders against the creditors of the account provider.

*Principle no. 2: An account holder has priority over any subsequent right created by a creditor action by the account provider's creditors whether individual or collective.*³²

Principle no. 2 applies regardless of whether:

- the account providers' account (at its account provider) is labeled as a customer account.
- there is a shortfall (see definition below)
- there is a surplus (commingling with account providers own securities)

Possible additional principle 2 a: Account holders also have priority over the creditors of the account provider with respect to securities held by the account provider on a non-customer account.

Is an adoption of principle no. 2 necessary to avoid legal uncertainty and transaction cost?

³¹ Conflict no. 1.

³² Conflict no. 18 and 21.

(awaiting finalization of Part III)

2.3. Equality of account holders of the same account provider. Shortfall-rule.

Principle no. 3: In case of shortfall account holders rank equally (share pro rata) with respect to securities of the same kind.³³

A shortfall is a situation, where the aggregate sum of the credits made on the account holders accounts exceeds the credits on their account provider's accounts with its upper-tier account provider, and the account provider is not able (usually due to insolvency) to cure the shortfall by buying in more securities. An account holder who is subject to reversal of a book entry to his account (e.g. because the account holder failed to pay for securities booked on his account) does not have the right to share pro rata with the other account holder, as the book entry does not represent a valid credit (but merely a reversible book entry).

Principle no. 3 applies regardless of whether an account holder has pledged his account or his account has been subject to a creditor action (e.g. insolvency proceedings), but in such cases the pledge/creditor may be entitled to the account holder's pro rata share of the remaining securities, cf. principle no. 6.³⁴

Is an adoption of principle no. 3 necessary to avoid legal uncertainty and transaction cost?

(awaiting finalization of Part III)

2.4. First-in-time priority between persons who acquire an interest in the same account.

Principle no. 4: A person who acquires an interest in an account holders account without having the securities transferred to his own account has priority over other persons who subsequently acquire an interest in the same account.³⁵

Principle no. 4 applies regardless of whether:

- the competing interests are acquired by contract or by creditor action (attachment or insolvency proceedings), but if an interest results in a transfer to the transferees own account principle no. 1 applies instead of no. 4.

³³ Conflict no.1.

³⁴ Conflict no. 2 and 4.

³⁵ Conflict no. 5 a, 5 c and 6 a.

Exceptions to principle no. 4:

a) A person who has not perfected his interest does not have priority over a person who by contract with the account holder acquires an interest in the account, provided the latter person perfects his interest [and at the time of perfection did not know or ought to have known about the previously created interest.]

b) A person who has not perfected his interest does not have priority over a person (including an insolvency administrator) who by attachment or initiation of insolvency proceedings acquired an interest in the account.

Requirements for perfection of an interest in an account: Determined by the law governing the account. However, there may be a need for common (minimum and maximum) substantive requirements for perfection.

Is an adoption of principle no. 4 necessary to avoid legal uncertainty and transaction cost? Should it be left to the law governing the account to determine the perfection requirements or should common (minimum and maximum) substantive requirements for perfection be formulated? (e.g. control, registration on the account or notification to the account provider). Should statutory liens granted under the law governing the account be given priority over other interests in the account? (awaiting finalization of Part III)

2.5. Bona fide acquisition of an interest in an account. Protection of a person who by contract acquires an interest in an account against reversal of the credits made on the account holders account.

Principle no. 5: If a person by contract with the account holder has acquired an interest in an account, the account provider may not reverse, invalidate or nullify a credit to the account for the reason that the credit was a result of an invalid contract or an error made by the account provider or others or that the account holder was himself acting as an account provider for others.³⁶

³⁶ Conflict no. 7 a, 10 a, 13, 16 b, 20 and 24.

Principle no. 5 does apply to persons acquiring an interest by a creditor action (creditors are not protected against reversal etc).³⁷

Exceptions/modifications to principle no. 5:

- a) The person who acquired the interest in the account knew or ought to have known (at the relevant time) that the credit to the account was a result of an invalid contract or an error.³⁸
- b) [The person who acquiring the interest in the account knew that the account holder was holding the securities on behalf of its account holders and that the account holder had no consent from its account holders to dispose over the securities].³⁹
- c) The account provider did not know or ought to have known about the acquiring person's interest in the account at the time when the reversal, invalidation or nullification of the credit was made. Perhaps this exception should be wider, so it allows for reversal etc. until reasonable time after the account provider know or ought to have known about the acquiring person's interest.
- d) The person acquiring the interest in the account is subject to the principle no. 3 (the shortfall rule) to the same extent as the account holder is.⁴⁰

Is an adoption of principle no. 5 necessary to avoid legal uncertainty and transaction cost?

(awaiting finalization of Part III)

2.6. Prohibition of “upper-tier attachment”. Protection of an account provider's right only to receive instructions from or with the consent of the account holder.

³⁷ Conflict no. 8, 11 and 14.

³⁸ Conflict no. 10 b.

³⁹ Conflict no. 16 b.

⁴⁰ Conflict no. 2.

Principle no. 6: An account provider is only entitled and obliged to follow an instruction to debit an account (and as the case may be make a resulting credit to another account) if the instruction is made by the account holder or with his consent.

Principle no. 6 applies regardless of whether:

- the account holder is himself acting as account provider for others.
- A person other than the account holder can prove that the account holder is maintaining securities on his behalf (no upper-tier attachment).
- A credit to the account holders account was a result of an error or an invalid contract (see however exception b).

Exceptions/modifications to principle no. 6:

- a) A person who by contract with the account holder acquired an interest in the account has to the extent stated in that contract the right to instruct the account provider to debit the account. However, if another person has better priority under principle no. 4, the account provider is not entitled to follow instructions from the person second-in-priority.⁴¹
- b) An account provider may debit the account holders account, if the account has been credited in error by the account provider, except if such debit (reversal of a credit) is contrary principle no. 5.
- c) An account provider is obliged to follow instructions from the insolvency administrator of the account holder, except if a person under principle no. 4 has priority over the insolvency administrator and that person has not consented to the instruction.

Limitation: The account provider is only obliged to instructions from the insolvency administrator if the decision to open insolvency proceedings is recognized under the law [of the state where account provider has its head

⁴¹ Conflict no. 7 a and 23.

office][of a state where the account provider has an office][of the state which governs the account].

- d) An account provider is obliged to debit an account if that follows from a court order issued against the account holder (e.g. in favour of a person who transferred the securities to the account holder under a voidable contract).⁴²

Limitation 1: The account provider is only obliged to follow court orders recognized under the law [of the state where account provider has its head office][of a state where the account provider has an office][of the state which governs the account].

Limitation 2: If a person other than the account holder and the person in favour of whom the court order is issued has an interest in the account, the account provider may only freeze the account until it is established who has the better priority in the account.

Is an adoption of principle no. 6 necessary to avoid legal uncertainty and transaction cost?

(awaiting finalization of Part III)

⁴² Conflict no. 9, 12, 17 and 19.