



**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**

UNIDROIT 2008
Study LXXVIII – Doc. 105
English only
January 2008

Informal Working Group on Article 14 of the draft Convention
Comments on the questionnaire concerning acquisition by an innocent person
(submitted by the Swiss delegation)

The Swiss delegation is grateful to the Chairman of the Working Group on Article 14 for his excellent Preliminary Note (Doc. 96) and offers the following answers and comments to the questionnaire.

1. *No Special Provision*

The Federal Intermediated Securities Act (FISA) presently considered by the Swiss Parliament includes a specific provision protecting a *bona fide* acquirer (Article 29, reprinted in the appendix) but does not include a good faith test specific to intermediated securities.

a) *General good faith test in a nutshell*

The applicable, general test is set out by Article 3 of the Civil Code of 1907, which reads:

Original French text

¹ La bonne foi est présumée, lorsque la loi en fait dépendre la naissance ou les effets d'un droit.

² Nul ne peut invoquer sa bonne foi, si elle est incompatible avec l'attention que les circonstances permettraient d'exiger de lui.

English translation

¹ If the law conditions the existence or effect of a right on good faith, such good faith will be presumed.

² No one shall be entitled to claim his good faith if such good faith would be incompatible with the attention required to be exercised by him under the circumstances.

Under Swiss law, the “good faith test” only applies when a legal provision refers to a party’s knowledge (or lack of knowledge) of specific facts. For example, Article 29 FISA protects an acquirer notwithstanding her ignorance that the transferor has no power to transfer intermediated

securities or that the credit to the transferor's account has been reversed. That protection depends on her not being aware of such facts. The good faith test relates to her state of mind in respect of the relevant facts.

Positive knowledge is exclusive of good faith.

Not only willful blindness but mere negligence is also exclusive of good faith. Article 3(2) of the Swiss Civil Code sets out a general standard of care by referring to the "attention que les circonstances permettaient d'exiger de lui." Courts have further defined this standard of care in respect of a *bona fide* purchaser of movable property:

- Article 3(2) of the Civil Code does not impose a general duty of investigation on the buyer. Such a duty only arises upon occurrence of specific suspicious circumstances.
- However, increased care is called when dealing in goods (such as luxury cars, antiques, etc., but not securities) for which the market is notoriously exposed to risks of theft or misappropriation.

b) Protection of an innocent acquirer of intermediated securities

Article 29 FISA protecting an innocent acquirer of intermediated securities is generally modeled after the general provisions of the Civil Code on movable property.

Two significant differences may be noted nonetheless:

- While the Civil Code does not protect *bona fide* acquisition of stolen registered certificated securities, FISA protects the purchaser of intermediated securities (or interests therein), whether in bearer or registered form and against whatever defect in the power of the transferor to dispose of such intermediated securities.
- *Bona fide* protection does not extend to gratuitous acquisitions.

The Federal Intermediated Securities Act does not set out its own standard of good faith nor clarifies whose knowledge is relevant when Article 29 applies to an entity.

2. Case law

There is no reported case dealing with the *bona fide* acquisition of securities held with an intermediary.

3. Other issues

FISA Article 29(5) states that a good faith transferee cannot object to the reversal of a credit when the conditions for such reversal are satisfied (Article 28). There are circumstances where a credit may be reversed because an instruction (and the relevant debit) resulting in that credit was not authorized. In such cases, the transferee may have to suffer a reversal of the credit notwithstanding her good faith as to the defective situation. However, if she had already disposed of the relevant securities in her own account while still in good faith, she is not required to buy in or otherwise restore the missing securities. This results from FISA Article 29(2) in conjunction with Article 64 of the Code of Obligations governing the claim for return of intermediated securities.

4. Article 14: Current text

We believe that Article 14 of the draft Convention is adequately described in the Working Paper. We find that two additions to the Paper would be helpful to delegations, observers, and readers generally.

(1) It would be most helpful to briefly explain how the protection of an innocent acquirer (Article 14) articulates with the priority among competing interests (Article 15). This question is raised in particular by the comments of the German delegation (Doc. 98, under 4.b). We believe that restricting the scope of Article 14 to rights acquired by credit to a securities account was a deliberate choice of the Committee of Governmental Experts addressing the need to unambiguously distinguish the respective scopes of Articles 14 and 15.

Under Article 14, the innocent acquisition of intermediated securities by credit to the account of an innocent acquirer trumps any previous interests in the securities. For example, secured lenders who held a collateral interest in the transferor's account lose their collateral interest. Extending Article 14 to the grant of interests under Article 10 would thoroughly disrupt the priority set out by Article 15 among interests in the same intermediated securities credited to the same account. For example, in a jurisdiction where interests may be granted by control agreements, a subsequent, junior collateral taker would be able to claim innocent protection to get priority over a senior collateral taker in the same securities.

Priorities are utterly important to secured lenders. Extending Article 14 to interests created under Article 10 would fundamentally disrupt the *prior tempore potior jure* priority set out in Article 15.

(2) The Working Paper correctly explains that Article 14(2) protects an innocent acquirer from earlier defective entry and thus serves "as a counterbalance" to the "jump into the unknown" caused by Article 13 referring the invalidity and reversal of book-entries to non-Convention (unharmonised) law.

However, it would be helpful to note that the counterbalancing effect of Article 14(2) is significantly diminished by Article 14(5) which, to the extent permitted by non-Convention law, allows any provision of the uniform rules of a securities settlement system or of the account agreement to displace the protection accorded by Article 14(2). The Swiss delegation questions the remaining value of Article 14(2) if paragraph 5 is maintained. We would object to extending Article 14(5) to Article 14(1) because it would shatter the whole idea of protection of innocent acquirers of intermediated securities against competing holders of previous interests.

5. Possible approaches

We believe the possible approaches have been correctly identified in the Working Paper.

We would suggest that all pros and cons of each approach be listed separately. (The cons of one approach may not always be addressed by the pros of another.)

We would add to the arguments against the first approach (reference to domestic law): the lack of a specific test for innocent acquisition of intermediated securities in most current legal systems, as well as the lack of case law providing guidance in respect of intermediated securities.

In respect of the second approach (autonomous test), which is favored by the Swiss delegation, we would note that having a test set out in the Convention does not yet mean that it will be applied uniformly by domestic jurisdictions. An autonomous test must be drafted in factual terms

(knowledge, significant probability, deliberately avoid are factual terms). Its application will nonetheless depend on which party, under the *lex fori*, bears the burden of proving or disproving innocence. The international experience in harmonizing private law suggests that it is quite impractical to allocate the burden of proof by a treaty provision.

While we doubt there is a remedy to this problem, we believe that the Working Paper should emphasize the need that any harmonized standard in respect of innocent acquisition sets out as clearly as feasible the facts upon which that protection relies.

Once the need for a factual test has been recognized, it becomes largely irrelevant whether the test is captured by words such as “good faith”, “bona fide”, or “innocent” acquisition. Such words are mere labels though they also convey some connotation to well established, national legal concepts.

Position of the Swiss delegation in respect of Article 14

The Swiss delegation firmly believes that the degree of legal certainty which this Convention strives to promote requires a uniform, factual test as to when an acquirer is protected against competing claims. If an autonomous test were an insuperable obstacle for some delegations, we could accept the possibility for a Contracting State to opt out by way of a declaration. We are rather indifferent as to whether that test should be labeled as innocence, *bona fides*, or good faith, but we are generally satisfied with the present drafting. We however question the real value of Article 14(2) protecting against prior defective entries given the huge potential carve-outs allowed by Article 14(5).

APPENDIX***FISA Articles 29 and 30***

We provide below an English translation of Articles 29 and 30 of the Federal Intermediated Securities Act which is presently being considered by the Swiss parliament. Changes to these provisions are not expected.

Article 29 Protection of the bona fide purchaser

¹ A person who acquires intermediated securities under Articles 24, 25 or 26 for value and in good faith shall be protected in respect of the acquisition even where:

- a. the transferor had no power or authority to transfer the intermediated securities; or
- b. the credit of intermediated securities to the transferor's securities account was reversed.

² A transferee who is not so protected is under a duty to reconstitute intermediated securities in the same quantity and of the same kind pursuant to the rules of the Code of Obligations on unjust enrichment. The rights of third parties shall not be affected. The foregoing is without prejudice to other claims based on the Code of Obligations.

³ Where the transferee who is bound to make restitution of the securities becomes subject to liquidation proceedings, the beneficiary may require intermediated securities in the same quantity and of the same kind to be excluded from the transferee's estate to the extent that it contains such intermediated securities.

⁴ Claims based on this Article shall be time barred one year after the holder of the debited account becomes aware of his rights and of the identity of his debtor, or at the latest ten years after the debit date.

⁵ Where the conditions for reversal of a credit under Article 28 are met, the transferee cannot object to the reversal on the basis of this Article.

Article 30 Priorities

¹ Where intermediated securities or interests in intermediated securities are disposed of pursuant to provisions of this Act, the disposition first in time shall prevail over further dispositions.

² Where a custodian has entered into an agreement with the account holder under Article 25, paragraph 1, without notifying the secured party expressly of its interests created earlier, such interest is deemed to be subject to the interest of the secured party.

³ Where intermediated securities or an interest in intermediated securities are assigned, the rights acquired pursuant to the provisions of this Act shall prevail over the assignee's rights, regardless of the time of the assignment.

⁴ The foregoing shall be without prejudice to agreements to modify the priorities of rights over intermediated securities, but such agreements shall be effective only as between the parties bound by them.