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GONZAGA UNIVERSITY SCHOOL OF LAW

Say Hello to the Hague Securities Convention

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The United States conflicts-of-law rules for transactions involving indirectly held securities are about to change. After years of anticipation, the Hague Securities Convention (the "Convention," also much more formally known as the Hague Convention on The Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary) will become effective as a matter of U.S. law on April 1, 2017.

Now is the time for U.S. lawyers to familiarize themselves with the Convention, because this new body of law will apply to all transactions within its scope – even those that were entered into before April 1. The good news is that, because of the Convention's careful drafting, most pre-April 1 transactions documented with attention to the applicable conflicts-of-law rules under the Uniform Commercial Code (the "U.C.C.") will not need amendment or other attention. However, there are certain exceptions, and, of course, transactions on and after April 1 should be entered into with the Convention's rules in mind.

This short piece sketches the Convention's main features, highlights important transition issues, and provides pointers to other resources.

Purpose and Outlook

In this globalized era, transactions involving indirectly held securities routinely involve parties or property from two or more nations. This fact makes conflicts-of-law rules essential. Transacting parties and courts need clear guidance on numerous commercial law issues. What law will apply to perfection and priority in a secured transaction in which the securities are collateral? What law will apply to the characterization of a transaction as being an outright transfer, a collateral transfer, or something else? What law will govern the mutual rights and obligations of a customer and its intermediary, or the exposure of these parties to an adverse claimant? What law will govern foreclosure or other remedies in the event of a default on a secured transaction?

For indirectly held securities (*i.e.*, those that are held through a broker, custodian bank or other intermediary, rather than directly on the issuer's books), U.C.C. § 8-110(b) and (e) already provide the basic conflicts-of-law rules, with U.C.C. §§ 9-305(a)(3), (c)(1) and 1-301(a) rounding out these rules for secured transactions. And these rules already cover international situations – but they are only *U.S.* conflicts-of-law rules, so they are very unlikely to apply in a non-U.S. forum.

The Convention sticks very close to the U.C.C. rules just mentioned, but it represents a large step forward to an eventual international harmonizing of conflicts-of-law rules. Now that the United States has ratified the Convention, it is expected that other nations will ratify as well, with the eventual result that the same law would reliably apply to a given transaction irrespective of the forum in which the transaction might eventually be disputed. It is advantageous for U.S. lawyers today to accommodate the Convention's small federal overlay on the U.C.C.'s rules, because this is a necessary prelude in which broad international harmonization will lead to identical choice of law rules applying in many other forums too.

The Convention's Broad Scope

The Convention applies broadly to the commercial law issues arising in what U.C.C. Article 8 calls the indirect holding system, in all transactions "involving a choice between the laws of different States." *See* Conv. art. 3. However, the Convention only applies to "securities" (defined in Conv. art. 1(1)(a) to include shares, bonds or other financial instruments or financial assets). It expressly excludes coverage of cash, and it does not have an opt-in mechanism like that of § 8-102(a)(9)(iii).

The term "State" as used in the Convention means "nation." The roster of international elements that can

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trigger application of the Convention is open-ended. It certainly includes the parties, the terms of the account agreement, the issuer of the securities, the location of any intermediary, and the location of any underlying security certificates. This is true notwithstanding that for many years U.S. practitioners have become comfortable with clear conflicts-of-law rules that ignore these aspects of a transaction. In fact, even a transaction that appears to be wholly U.S. domestic can turn out to be covered by the Convention. For example, suppose that securities of a non-U.S. issuer are later credited to the securities account – or that a non-U.S. adverse claimant asserts an adverse claim to some of the securities. *A smart U.S. lawyer, then, will always plan transactions on the assumption that the Convention applies.*

In addition to the U.S., the only nations currently party to the Convention are Switzerland and Mauritius. However, the Convention applies in a U.S. forum regardless of whether the non-U.S. nation in question has also ratified the Convention. If there is a Japanese secured party or a Belgian intermediary, the Convention applies.

UCC § 8-110(e) with a Dose of Reality

As U.S. lawyers know, the U.C.C. provides that the applicable law for most Article 8 and 9 issues may be designated either by a governing law clause, *see* § 8-110(e)(2), or by a more specialized clause expressly designating "the securities intermediary's jurisdiction," *see* § 8-110(e)(1). The Convention's basic rule is almost exactly the same, with the addition of one reality-based component.

Convention art. 4(1) provides, "The law applicable to all the issues specified in Article 2(1) [scope] is the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement," *cf.* the U.C.C.'s subsection (e)(2), "or, if the account agreement expressly provides that another law is applicable to all such issues, that other law." *Cf.* the U.C.C.'s subsection (e)(1).

The fact that "State" in the Convention means "nation" does not interfere with the contractual designation of a U.S. "state" such as New York. *See* Conv. art. 12(1)(a) (reference to "State" is to the "territorial unit of a multi-unit State"). Note, however, that the U.C.C.'s formulation ("securities intermediary's jurisdiction" rather than "all the issues specified in Article 2(1)") would be of questionable effect in achieving the expected result under the Convention. Here is a possible formulation for the account agreement that should work under both U.C.C. § 8-110 and the Convention:

> **For purposes of the Uniform Commercial Code, the 'securities intermediary's jurisdiction' shall be the State of New York. The parties further agree that the law applicable to all the issues in Article 2(1) of The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary shall be the law of the State of New York.**

Unless there is no doubt that the securities account will contain only assets that constitute "securities" under the Convention (and not, for example, cash as a financial asset or some other asset a securities intermediary has agreed to treat as a financial asset that would not qualify as a security under the Convention, both the U.C.C. formulation and the Convention formulation should be used. Of course, simply selecting New York as the law governing the entire account agreement would also work. Note, however, that the Convention requires the selection of applicable law to be in the account agreement itself, so selections placed in an external document such as a control agreement might not have the desired effect unless they act to amend the account agreement.

But now let us note the Convention's reality-based component, which is informally known as the Qualifying Office test. Unlike under U.C.C. § 8-110 standing alone, the Convention-approved methods for selecting the applicable law are effective only if the intermediary "has, at the time of the agreement, an office in that State, which . . . is . . . engaged in a business or other regular activity of maintaining securities accounts." This requirement is satisfied on a safe-harbor basis if the intermediary "effects or monitors entries to securities accounts" in the office, or "administers payments or corporate actions relating to securities held with the intermediary" in the office. This activity does not have to relate to the particular securities account in question. (Conversely, the requirement is not satisfied merely because the office is a call center for account holders, a location of computers, or location for other specified mechanistic or administrative functions.) Conv. art. 4(1), (2).

If the account agreement designates a state of the United States or other multi-unit state, the Qualifying Office requirement is satisfied if the office is anywhere in the national "State," so that a designation of New York law is effective even if the intermediary's only qualifying activity is in New Jersey. Conv. art. 12(1)(b). Overall, the Qualifying Office requirement is rather minimal and should interfere with only unusual transactions. Its inclusion within the Convention is a sensible accommodation for (and compromise by) other nations' systems, with an eye toward eventual wide ratification.

Accommodating Article 9's Filing Rules (Almost Seamlessly)

The Convention generally also accommodates very well a peculiarity of U.S. law, namely U.C.C. Article 9's rules for perfection of a security interest by the filing of a financing statement. Recall that when the collateral is intermediated securities, § 9-305(a)(3) provides that the law governing perfection, plus the effect of perfection or non-perfection and priority, is the securities intermediary's jurisdiction - thereby departing from Article 9's ordinary choice of law rules in § 9-301(1). But when the method of perfection in the intermediated securities is filing, § 9-305(c)(1) returns us to the ordinary rule for perfection (though *not* for the effect of perfection or non-perfection or priority). That is, security interests in intermediated securities can be perfected by a financing statement filed in the jurisdiction in which the debtor is located, as determined under § 9 307, just like security interests in any other collateral.

Convention art. 12(2)(b) accommodates this rule by providing that "if the law in force in a territorial unit of a Multi-unit State designates the law of another territorial unit of that State to govern perfection by public filing, recording or registration, the law of that other territorial unit governs that issue." For example, suppose that the debtor is a Texas corporation, and that the account agreement designates New York as the governing law (with no other clause governing the Convention article 2(1) issues, and the Qualifying Office test being satisfied). The U.C.C. rules just mentioned would instruct the secured party to file in Texas – and the Convention leads to exactly the same result, because "the law in force in a territorial unit [here, New York] of a Multi-unit State [here, the U.S.] designates the law of another territorial unit of that State [here, Texas] to govern perfection by public filing."

But the Convention's accommodation has two limitations. First, the Convention does not accommodate the Article 9 filing rules for transactions in which the account agreement designates non-U.S. law (for example, the debtor is a Texas corporation but the account agreement designates English law). And second, the Convention does not accommodate the Article 9 filing rules for transactions involving a debtor located outside of the U.S. (for example, an Ontario corporation having its chief executive office in Toronto), even if the account agreement designates U.S. law (for example, that of New York). Instead – in the single most surprising change of law under the Convention – if the secured party in this second scenario wishes to perfect by filing, it should do so in the state designated by the account agreement. After all, that is the applicable law! Both of these relatively unusual situations are more fully analyzed in a Commentary that is expected to be finalized soon by the Permanent Editorial Board for the U.C.C., and a draft of which is posted on the PEB's web site.

Beware of Occasional Transition Wrinkles, Too

As noted above, most transactions that are already in place in advance of April 1 will not need amendment or other attention. But there are a small handful of potential issues for some transactions, and lawyers who are responsible for ongoing oversight or advice in connection with existing deals will want to determine whether these issues are present.

Account agreements in pre-April 1 deals will generally continue to effectively designate the governing law, regardless of whether the agreement has heretofore used a governing law clause under § 8-110(e)(2) or an express designation of "the securities intermediary's jurisdiction" under subsection (e)(1). *See* Conv. art. 16(3). However, this is true only if the securities intermediary satisfies the Qualifying Office requirement in the "State" (*i.e.*, nation) designated. Thus a choice-of-law clause designating New York law will not continue to be effective if the intermediary's only operations are in Belgium. Also, if the law designated is not that of a U.S. jurisdiction, then the operation of Conv. art. 16(3) depends on the provisions of that non-U.S. law (*i.e.*, would that law "give effect" to the choice of law in the way that choice would operate under the Convention).

Financing statements for pre-April 1 deals will also generally continue to be effective for perfection. However, there are two exceptions, corresponding to the two limitations noted above on Article 9 filing under the Convention. Specifically, if the account agreement designates non-U.S. law, then the secured party's perfection after April 1 is governed by that non-U.S. law – regardless of what a U.S. state's Article 9 might say about the debtor's location.

Similarly, if the account agreement designates the law of a U.S. jurisdiction, but Article 9 deems the debtor to be located outside of the U.S., then the secured party's perfection after April 1 is governed by the U.S. jurisdiction – but this is not to say that the filing (or other recordation or registration) outside the U.S. will continue to be effective. Suppose that the account agreement designates New York law, but that New York's Article 9 deems the debtor to be located in Ontario; as a result the pre-April 1 filing under Ontario's Personal Property Security Act (the "PPSA") will likely have only limited continued effect under New York law. The secured party should ideally re-file in New York before April 1, though perhaps a New York court would allow a four-month grace period after April 1, borrowing from N.Y.U.C.C.

§ 9-316(a)(2) or (f). Of course, until Canada adopts the Convention, the PPSA filing will remain relevant if the issue is addressed by a Canadian court (*e.g.*, in a Canadian bankruptcy proceeding).

For Further Information

The brief points set forth above may be supplemented in several ways. The P.E.B. Commentary noted above will be one obviously valuable source, and it is expected to include amendments to the Official Comments to U.C.C. §§ 8-110, 9-305, 1-301 and 9-301. In addition, continuing legal education sessions are being scheduled in various venues during the coming months, and additional publications are likely. For an exhaustive treatment of the Convention, see the Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, authored in 2005 by Roy Goode, Hideki Kanda and Karl Kreuzer, with the assistance of Christophe Bernasconi.

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Representations & Warranties of Solvency

Stephen L. Sepinuck

In a recent deal on which I consulted, a newly formed, thinly capitalized entity was to borrow a substantial sum and use the proceeds to invest in loans. The lender wanted the borrower to represent and warrant that it was solvent, but the borrower's counsel pushed back, arguing that, due to the fees associated with the impending loan, the borrower might well be insolvent when the loan was made. The parties eventually agreed not to include a representation and warranty of solvency at the time the loan documents were executed, but to require a certificate of solvency for future advances. The question remains, however, whether either option – the initially requested representation and warranty or the later certificate – is necessary. Put another way, what purpose would or could a borrower's representation or warranty of solvency have?

In some transactions, a representation of solvency is undoubtedly useful. For example, in a domestic sale of goods governed by Article 2 of the Uniform Commercial Code, a seller has a right to reclaim the goods from an insolvent buyer if the seller makes a demand therefor within ten days after the buyer received the goods.[1] However, this rather strict ten-day limit does not apply if the buyer has provided the seller with a written misrepresentation of solvency within the prior three months.[2] So, getting the buyer to represent solvency can extend the time during which the seller may reclaim the goods.[3]

In addition, a misrepresentation of a *third party's* solvency can be actionable, creating a claim for fraudulent inducement.[4] Moreover, on occasion a misrepresentation of *insolvency* (*i.e.*, a party's false representation that the party is insolvent) can provide a basis for rescission of a settlement agreement.[5]

But none of these situations involves a borrower representing and warranting its own solvency. Given that a borrower will, unless the loan is made on a nonrecourse basis,[6] be liable for the loan, it is not clear what additional benefit or right could flow to the lender if the borrower falsely represented, or breached a warranty of, solvency.

A fraudulent misrepresentation might give rise to a right to rescind, but contract liability on the loan is likely to be greater that any right of restitution upon rescission. Similarly, a breach of a warranty of solvency would add nothing to the borrower's contract liability to repay the debt, particularly if insolvency itself was an event of default and gave rise to default charges and interest. It might make some sense to require the borrower to represent and warrant solvency as a condition to the borrower's right to draw on a line of credit or otherwise obtain future advances, but even then the representation and warranty would be of limited utility. The misrepresentation or breach might not be discovered until after the borrower received the additional funds and, in any event, solvency is a poor measure of creditworthiness. Finally, a written misrepresentation of solvency by a borrower can be a basis for making the resulting indebtedness nondischargeable in the borrower's bankruptcy proceeding.[7] However, that would normally be relevant only when the borrower is an individual.[8] A business entity gets no discharge in Chapter 7,[9] and the scope of such an entity's discharge in a Chapter 11 case is determined by the plan, not by nondischargeability rules.[10]

So, if a representation and warranty of solvency serves little purpose in a business loan, why is it common to find such a term in business loan documents?[11] The answer might lie in the Bankruptcy Act of 1898, which

limited preferential transfers to those in which the transferee "had reasonable cause to believe that it was intended thereby to give a preference.[12] Courts interpreted that phrase to require that the transferee had reasonable cause to believe that the debtor was insolvent.[13]

But the Bankruptcy Act was replaced in 1979 by the Bankruptcy Code, under which knowledge or notice of insolvency is not an element of a preference.[14] If the Act was in fact the impetus for including a representation and warranty of solvency in loan agreements, it is past time for those transaction documents to be updated.

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Notes:

1. U.C.C. § 2-702(2).

2. *Id.*

3. That said, because the seller's reclamation rights are subject to the rights of the buyer's secured party, *see* U.C.C. § 2-702(3); In re Advance Mktg. Sys., 360 B.R. 421 (Bankr. D. Del. 2007), extending such rights might not matter. Morever, if the buyer becomes the debtor in a bankruptcy proceeding, the seller's reclamation rights will expire no later than 45 days after the buyer received the goods, *see* 11 U.S.C. § 546(c)(2), so a written misrepresentation of solvency is rarely likely to extend the seller's reclamation rights more than 35 days. *See also* In re Leonard, 2016 WL 1417964 at *8 (Bankr. D. Neb. 2016); In re Momenta, Inc., 455 B.R. 353, 358 (Bankr. D.N.H. 2011); In re Circuit City Stores, Inc., 441 B.R. 496, 505 (Bankr. E.D. Va. 2010); In re Magwood, 2008 WL 509635 (Bankr. M.D. Ala. 2008); In re Dana Corp., 367 B.R. 409, 418 (Bankr. S.D.N.Y. 2007) (each indicating that § 546(c) does not create an independent federal right of reclamation but simply allows a seller to exercise its state law remedies under the U.C.C. with certain limitations).

4. Rossetti v. Ambulatory Surgery Center of Brooklyn, LLC, 5 N.Y.S.3d 373 (N.Y. Sup. Ct. 2015).

5. *See, e.g.*, Russell Land Co. v. Mandan Chrysler-Plymouth, Inc., 377 N.W.2d 549 (N.D. 1985) (settlement agreement was properly rescinded based on one party's misrepresentation that it was bankrupt).

6. If the loan is nonrecourse, a misrepresentation of solvency could be used to trigger recourse liability. This type of "bad-boy" term can be useful.

7. *See* 11 U.S.C. § 523(a)(2)(B).

8. *See* 11 U.S.C. §§ 727(b), 1141(d)(2), 1328(a)(2).

9. *See* 11 U.S.C. § 727(a)(1).

10. *See* 11 U.S.C. § 1141(a), (d).

11. *See, e.g.,* Woodberry v. Graham, 2017 WL 151617 (S.D.N.Y. 2017) (in which a borrower represented and warranted that is was solvent).

12. 11 U.S.C. § 60(b) (repealed).

13. *See, e.g.,* Bank of Commerce v. Brown, 249 F. 37 (4th Cir. 1918); Hussey v. Richardson-Roberts Dry Goods Co., 148 F. 598 (8th Cir. 1906).

14. *See* Pub. L. 95-598, § 402(a).

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Recent Cases

SECURED TRANSACTIONS

Morris–Rivers, LLC v. Sonic Cavitation, LLC,
2016 WL 7341703 (D. Nev. 2016)

A secured party was not entitled to a preliminary injunction prohibiting the debtor from relocating two generator pumps – the debtor's only remaining valuable assets – because, among other reasons, the security agreement described the collateral as all of the debtor's "equipment owned . . . on the Maturity Date" and there was evidence that the equipment was not manufactured until after the Maturity Date.

International Manufacturing Group, Inc. v. McFarland,
2016 WL 7163588 (Bankr. E.D. Cal. 2016)

A business loan agreement that described the indebtedness secured as including a "Note," which was in turn defined to include "any other subsequent Notes evidencing future indebtedness," was sufficient to make the collateral secure future advances even though the agreement did not otherwise expressly refer to "future advances."

In re Jett,
2017 WL 112525 (Bankr. S.D. Miss. 2017)

Because the transformation rule, not the dual-status rule, should be applied to PMSIs in consumer goods, a bank's PMSI in the debtors' vehicle lost purchase-money status when the debtors and bank refinanced the debt and included in it two previously unsecured loans. As a result, the bank's claim could be modified in the debtor's bankruptcy proceeding.

BANKRUPTCY

In re Tempnology LLC,
559 B.R. 809 (1st Cir. BAP 2016)
The debtor's rejection of an executory contract under which the debtor granted the counter-party the exclusive right to distribute its products and a license of its trademarks did not terminate the trademark license. Although the counter-party's election under § 365(n) did nothing to preserve the trademark licence because trademarks are not within the Bankruptcy Code's definition of "intellectual property," rejection of the contract was merely a breach, not a termination or rescission. However, rejection of the contract did, apparently, terminate the counter-party's exclusive distribution rights.

GUARANTIES

CP III Rincon Towers, Inc. v. Cohen,
2016 WL 6989480 (2d Cir. 2016)
A term in a bad-boy guaranty providing that the creation of any voluntary lien on the collateral triggered the guarantor's liability rendered ambiguous another term triggering liability on any "transfer" of the collateral, a term defined to include the creation of any lien, whether voluntarily or involuntarily.

United States v. Kumar,
2016 WL 7369863 (N.D. Cal. 2016)
Individuals who guaranteed an SBA loan to their limited liability company, secured by a deed of trust, raised a potentially valid defense to a deficiency claim by alleging that the guaranty was a sham intended to evade the anti-deficiency statute. They claimed that the lender asked for the financial information of only the guarantors, not the borrower, and that it required that the loan be made to a special purpose entity, which was formed for the purpose of taking title to the real property.

Follow the link below for a detailed list of

2016 Commercial Law Developments

The file synopsizes more than 300 judicial decisions

LENDING & CONTRACTING

In re Caesars Entertainment Operating Co.,
2016 WL 7451305 (Bankr. N.D. Ill. 2016)
Although a term in a collateral agreement by which the lenders agreed that "no recourse shall be had . . . under any law," against the borrowers or their assets, other than the specified collateral, might by itself be sufficient to waive the lenders' right to make the election under § 1111(b) of the Bankruptcy Code, because the collateral agreement had to be read consistently with the contemporaneously executed intercreditor agreement, which expressly referred to the collateral agent making the election, the lenders had not waived their right to make the election.

In re Kang,
2016 WL 6958438 (4th Cir. 2016)
Restrictions in a limited liability company's operating agreement on the encumbrance of LLC property and the transfer of membership interests – which were added to protect the interests of a lender – were enforceable and rendered a transfer of membership interests in violation of the restriction void.

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