IN OUR OPINION

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RECENT DEVELOPMENTS

Security Interest Opinions Under The Hague Securities Convention

The Hague Securities Convention became effective as a matter of U.S. law on April 1, 2017.[8] It provides choice-of-law rules for many commercial law issues affecting intermediated securities and thereby preempts portions of the corresponding choice-of-law rules provided or mandated by the common law, Articles 1, 8 and 9 of the Uniform Commercial Code ("UCC") and by related federal book-entry regulations.[9] In most cases, the choice-of-law results under the Convention will be the same as those under the UCC, but there are some differences. This article addresses those differences as they affect opinions of counsel, primarily regarding enforceability and perfection of security interests.

The Convention's choice-of-law rules apply to a wide range of commercial law issues affecting the ownership or transfer of interests in "securities held with an intermediary,"[10] which generally tracks what U.S. lawyers know as UCC Article 8's indirect holding system. The Convention defines "securities" as "any shares, bonds or other financial instruments or financial assets (other than cash), or any interest therein,"[11] a definition broader in some respects than the corresponding one in UCC Article 8. However, the Convention's scope is fixed, in contrast to the scope of UCC Article 8, which is subject to expansion beyond securities by agreement between the intermediary and its customer or account holder.[12] The Convention's exclusion of "cash" (i.e., credit balances) from the definition of "securities" also contrasts with the UCC Article 8 system.[13] Nonetheless, the Convention is designed like the UCC to be flexible in scope overall, with fluid, broad

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[8] The Convention is formally known as the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary. Its text is available on the web site of the Hague Conference on Private International Law at https://www.hcch.net/en/instruments/conventions/full-text/?cid=72. For more detailed treatment of the Convention, *see, e.g.*, PEB Commentary No. 19, Hague Securities Convention's Effect On Determining the Applicable Law for Indirectly Held Securities (April 11, 2017); Carl S. Bjerre, Sandra M. Rocks and Edwin E. Smith, Changes in the Choice of Law Rules for Intermediated Securities: The Hague Securities Convention is Now Live (forthcoming, Business Law Today, _____ 2017); Roy Goode, Hideki Kanda, and Karl Kreuzer, with the assistance of Christophe Bernasconi (Permanent Bureau), Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (2d ed. 2017), available at https://www.hcch.net/en/instruments/conventions/publications1/?dtid=3&cid=72.

[9] *E.g.*, 31 C.F.R. 357.10 *et seq.* (TRADES regulations).

[10] *See* Conv. art. 2(1) (listing the issues covered).

[11] Conv. art. 1(1)(a).

[12] *See* UCC §§ 8-501(a) (defining "securities account" as an account to which financial assets may be credited), 8-102(a)(9)(iii) (scope of financial asset is subject to agreement). The Convention uses "financial asset" as part of its definition of "security," but it does not define the term financial asset.

[13] Credit balances may be covered under UCC Article 8 either because they are considered part of the securities account itself or because the intermediary and customer have agreed to treat them as a financial asset. *See* UCC § 9-108 cmt. 4 ("[A] security interest in a securities account would include credit balances due to the debtor from the securities intermediary, whether or not they are proceeds of a security entitlement."); UCC § 9-314 cmt. 3 ("This claim would be analogous to a 'credit balance' in the securities account, which is a component of the securities account even though it is a personal claim against the intermediary.").

coverage that will meet the demands of market practices.[14]

The Convention applies to any transaction or dispute "involving a choice" between the laws of two or more nations[15] — a circumstance that may arise in any intermediated securities transaction, either at the transaction's outset or later in its life. Without limitation, the "choice" will be involved whenever any of the issuer, the underlying certificates or the issuer's books, or a wide range of parties (including account holder, intermediary, clearing corporation, secured party, adverse claimant, creditor of account holder, and creditor of intermediary) have connecting factors to different nations, regardless of whether the nations in question are parties to the Convention.[16] It should also be emphasized that many of these elements, while having been acknowledged by U.S. lawyers for general transaction planning purposes, have been immaterial to a choice-of-law analysis under UCC §§ 8-110 and 9-305 alone.

Given the very broad range of facts that can cause the Convention's "choice" to arise, it is advisable that virtually every intermediated securities transaction be planned with both the Convention and the UCC in mind. For purposes of opinion giving, at the most basic level this will include taking assumptions or otherwise confirming (a) that the account in question is a "securities account" as defined in both the Convention and the UCC,[17] and (b) that the broker, custodian bank, clearing corporation or similar party is an "intermediary" as defined in the Convention and a "securities intermediary" as defined in the UCC.[18]

The commercial law issues to which the Convention applies are those (and only those) enumerated in Convention article 2(1). The issues are expressed in broad and sometimes overlapping terms, but for purposes of this article it suffices to note that the issues clearly include perfection of a security interest and the exercise of remedies against collateral. A number of other important issues are also covered by the Convention, including priority (not discussed in this article because security interest opinions cover priority only in specialized circumstances), whether a purchaser takes free of adverse claims (also not discussed here because opinions in secondary sales transactions are a separate subject), and the characterization of a transaction as being a collateral transfer to secure an obligation or an outright disposition as against third parties.

A. Perfection

While opinions on perfection typically do not expressly address choice of law,[19] they nonetheless implicate choice-of-law rules indirectly. This is because of the principle that a lawyer should not give an opinion that the

[14] The Explanatory Report, referring to "exchange traded financial futures and options" and to credit default swaps, suggests that securities held with an intermediary for purposes of the Convention could encompass some assets that might be considered commodity contracts or might otherwise not be considered securities or other financial assets under the UCC.

[15] Conv. art. 3.

[16] Conv. art. 9.

[17] *See* Conv. art. 1(1)(b); UCC § 8-501(a). As a matter of customary practice, security interest opinions are not typically understood to cover the classification of collateral. Cf. Special Report of the TriBar Opinion Committee: U.C.C. Security Interest Opinions – Revised Article 9, 58 Bus. Law. 1449, 1467 n.79 (2003) ("The attachment opinion covers the *legal* sufficiency of the description of the collateral, but not its *factual* accuracy . . . . The opinion preparers are expected to determine whether the description of the collateral is, as a matter of law, sufficient, but do not have to inspect the collateral to determine whether the description of collateral is factually correct or accurate." (emphasis in original)).

[18] *See* Conv. art 1(1)(c); UCC § 8-102(a)(14).

[19] *See* Special Report of the TriBar Opinion Committee, supra note 10, at 1460.

lawyer believes would be misleading.[20] To opine on perfection or enforceability under the law of a given jurisdiction is, by implication, to suggest that it is reasonable to conclude that the jurisdiction is in fact one to which the applicable choice-of-law rules point with respect to some component of the relevant collateral. Accordingly, with the Convention now sometimes pointing to a different jurisdiction's law for perfection purposes than would the UCC alone, counsel who are asked to give opinions on perfection in transactions within the Convention's scope will want to take a fresh look at the applicable law and the transaction documents or other underlying facts. Some perfection opinions that posed no issue of being misleading before April 1, 2017, may now pose one, and vice versa.

The transactions that potentially pose such an issue differ, depending on whether the secured party intends to perfect by control or by filing.

1. Perfection by Control: the Primary Rule, Transition Rules and Fallback Rules

For secured parties intending to perfect by control, the Convention's so-called "Primary Rule" is the principal focus. The Primary Rule, which appears in article 4(1), permits the intermediary and debtor/customer to choose the applicable law for all of the article 2(1) issues by means of a provision in the account agreement.[21] Either of two types of provision can serve this purpose: an express general governing law clause, or an express provision that a particular law is applicable to all of the article 2(1) issues.[22] Many readers will note that both of these are directly parallel to the provisions on which the UCC's main choice-of-law provisions also depend, namely UCC § 8-110(e)(1) and (e)(2). An important limitation, imposed only by the Convention and not the UCC, is that the account agreement provision is effective only if it designates the law of a jurisdiction in which the intermediary has a "Qualifying Office" — a topic further discussed below. For account agreements entered into before the April 1, 2017, the Convention provides two transition rules that under certain conditions will assure an agreement's effectiveness after April 1.[23] For account agreements that do not effectively

[20] *See* Committee on Legal Opinions, ABA Section of Business Law, Guidelines for the Preparation of Closing Opinions, 57 Bus. Law. 875, 876 (2002); TriBar Opinion Committee, Third-Party "Closing" Opinions, 53 Bus. Law. 592, 602-03 (1998) (hereinafter "1998 TriBar Report").

[21] The meaning of "account agreement" is worth pausing over. The Convention's definition of account agreement refers to "*the* agreement" between those parties governing the account. Conv. art. 1(1)(e). The Explanatory Report makes clear that this agreement may consist of more than one document; however, it is probably advisable for opinion givers to avoid relying on the law designated only in a free-standing control agreement as the applicable law unless the control agreement amends the chosen law of the account agreement to designate the applicable law.

[22] Conv. art. 4(1) (". . . the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law").

[23] *See* Conv. art. 16(3) (giving this effect to "express terms of an account agreement which would have the effect, under the rules of the State whose law governs that agreement, that the law in force in a particular State, or a territorial unit of a particular Multi-unit State, applies to any of the issues specified in Article 2(1)"); Conv. art. 16(4) (giving this effect to an agreement "that the securities account is maintained in a particular State, or a territorial unit of a particular Multi-unit State"). Both of the transition rules are subject to the Qualifying Office requirement, and both are framed as "interpretations" of the Primary Rule. *See, e.g.*, Explanatory Report ¶¶ 16-1 to 16-9.

designate the law of a jurisdiction under the Primary Rule or the transition rules, the Convention sets out a cascade of fallback rules that determine the applicable law.[24]

The core of the Primary Rule's Qualifying Office requirement (which is also an element of the transition rules and the first fallback rule) is that the law designated by the account agreement must be that of a jurisdiction in which the intermediary has, at the time the agreement (or a relevant amendment) is entered into, an office engaged in the business or other regular activity of maintaining securities accounts.[25] For "Multi-unit States" such as the United States,[26] the office may be located anywhere in the Multi-unit State; for example, a governing law clause in an account agreement designating the law of New York will be given effect even if the intermediary's only U.S. office is in Atlanta.

In order to avoid the possibility of misleading the recipient, an opinion on perfection by control should not be given unless the opinion giver is sufficiently confident — or takes an assumption — that the Convention points to the law of the opining (or "covered") jurisdiction under the Primary Rule (or transition or fallback rules). As a means of reaching this confidence in the absence of an assumption, the opinion giver might rely on a certified copy of the account agreement, or a representation or certification from the intermediary. Relatedly, to cover the Qualifying Office requirement, the opinion might rely on a representation or certification from the intermediary, or an assumption might be taken; and in either case the applicable language should be focused on the correct point in time, which may have preceded the closing of the transaction and the rendering of the opinion.[27] Alternatively, the opinion giver could exclude the possible effect of the Convention from the scope of the opinion.

2. *Perfection by Filing*

For secured parties intending to perfect by the filing of a UCC financing statement, the Convention brings two additional potential changes for opinion givers. Each is applicable only under limited circumstances. The first involves transactions in which the Primary Rule (or the transition or fallback rules, as the case may be) designates the law of a non-U.S. jurisdiction. The second involves transactions in which UCC Article 9 provides that the debtor is located in a non-U.S. jurisdiction.

The first change applies to transactions in which the Primary Rule (or the transition or the fallback rules) designates the law of a non-U.S. jurisdiction; in such event, that non-U.S. law determines the jurisdiction (if any) in which to perfect by filing.[28] This is a notable departure from the choice-of-law rules provided by the UCC alone, where the sole determinant of the

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[24] *See* Conv. art. 5(1), (2), (3). These fallback rules are similar in structure to UCC § 8-110(e)(3), (4) and (5), but differ in their particulars.

The Convention's rules generally do not include any renvoi; in other words, the law designated by the Convention does not include the designated jurisdiction's own choice-of-law rules. This parallels the UCC's designation of jurisdictions' "local law" in §§ 8-110, 9-305 and elsewhere. The only exception (a limited, but important, internal renvoi relating to perfection by filing under Conv. art. 12(2)(b)) is addressed below. See note 34.

[25] Conv art. 4(1), second sentence. The maintenance of accounts may be carried out by the office alone or together with other offices, and the accounts maintained at the office need not include the account that is the subject of the transaction. *See generally* Explanatory Report ¶¶ 4-21 to 4-40; *see also* Carl S. Bjerre and Sandra M. Rocks, A Transactional Approach to the Hague Securities Convention, 3 Capital Markets L.J. 109, 119–21 (2008).

[26] *See* Conv. art. 1(1)(m).

[27] In cases where the account agreement is amended so as to change the law that it expressly designates, the Qualifying Office requirement must be satisfied at the time of the amendment. *See* Explanatory Report ¶ 4-28.

[28] Conv. art. 2(1)(c) (Convention governs the requirements, if any, for perfection of a disposition). In this respect the Convention's rules for perfection by filing do not differ from those for perfection by control, discussed above.

jurisdiction in which to perfect by filing has been the location of the debtor, and where the law designated by the account agreement or by § 8-110's fallback rules has been immaterial.[29] For example, under the UCC a corporate debtor that is organized under the law of New York is located in New York,[30] and the result has been that an opinion limited to New York law can cover perfection of a security interest by filing in the New York Secretary of State's office. The same result continues under the Convention if the Primary Rule (or the transition or fallback rules) designates the law of New York.[31] But if, say, the Primary Rule designates the law of a non-U.S. jurisdiction such as England, then that non-U.S. law applies to perfection, with the effect that it ousts any application of the UCC's place of filing rules. Thus, a New York law opinion on perfection by filing could, at least in certain circumstances, be misleading if the opinion does not cover the jurisdiction determined under the Convention or does not exclude the Convention from the scope of the opinion and the opinion giver believes that the opinion would be misleading to the opinion recipient.[32]

So long as the Primary Rule (or the transition or fallback rules) designates the law of a U.S. jurisdiction, then the Convention does an impressively good job of accommodating UCC Article 9's own rules regarding the location in which to perfect by filing — except when Article 9 provides that the debtor is located in a non-U.S. jurisdiction. Suppose that the account agreement effectively designates the law of New York under the Primary Rule, but that the debtor is a corporation organized under the law of Ontario, Canada with its chief executive office in Toronto. Under UCC Article 9 alone, perfection by filing would be appropriate in Ontario under its Personal Property Security Act;[33] but under the Convention, the UCC Article 9 rules are recognized only "if the law in force in a territorial unit [here, New York] of a Multi-unit State [here, the United States] designates the law of another territorial unit of that State to govern perfection by public filing, recording or registration."[34] As Ontario is not a territorial unit of the United States, the result is that Ontario law, and thus an Ontario PPSA filing, is not recognized as applicable or relevant under U.S. law to the extent the Convention

[29] *See* UCC §§ 9-305(c)(1) (perfection by filing depends on law of location of debtor); 9-307 (determining location of debtor).

[30] *See* UCC §§ 9-307(e), 9-102(a)(71).

[31] Under purely U.S. variations on these facts, analogous substantive results also continue under the Convention, but whether an opinion on perfection by filing should be given on those variations depends on a law firm's policies regarding filing in other U.S. jurisdictions. If the Primary Rule designates the law of New York but Article 9 provides that the debtor is located in, say, the District of Columbia, then perfection by filing continues to be substantively appropriate in the District of Columbia (see discussion of Conv. art. 12(2)(b) below); however under the Convention just as under the UCC alone, law firms' willingness to cover District of Columbia law for this purpose may vary. Conversely, if Article 9 provides that the debtor is located in New York but, say, the Primary Rule designates the law of Pennsylvania, then perfection by filing continues to be substantively appropriate in New York; however under the Convention law firms' willingness to cover the law of Pennsylvania for this purpose may vary.

[32] There is an an argument that such an opinion would not be misleading in transactions where the collateral consisting of securities held with an intermediary is not a material part of the collateral as a whole that the opinion covers. This argument would not apply to the secondary sale context, in which the securities (often delivered through an intermediary) are the only subject of the opinion letter.

[33] *See* UCC §§ 9-305(c)(1), 9-307(b)(3).

[34] Conv. art. 12(2)(b). This is the limited internal renvoi referred to above.

applies.[35] Instead, rather surprisingly, the Convention calls for filing in New York, because perfection is one of the article 2(1) issues and the Primary Rule points to New York. For opinion purposes, the change here is the relevance and effect of a New York filing, rather than the non-recognition of an Ontario filing, because a U.S. opinion giver would not be covering an Ontario filing even in the absence of the Convention. Of course Canadian law would typically remain relevant to other significant matters — such as the effects of an insolvency in the debtor's home jurisdiction — even if, as will often be unlikely, there is no other relevant collateral involved in the transaction.

B. Remedies/Enforceability

The issues enumerated in Convention article 2(1) include "the requirements, if any, for the realisation of an interest in securities held with an intermediary." This includes collateral-based remedies such as foreclosure of a security interest in intermediated securities.[36] The fact that the Convention covers this topic constitutes a notable substantive change as compared to choice of law under the UCC alone.[37] It may also deserve some thought by opinion givers in connection with remedies opinions on security agreements that cover intermediated securities, *i.e.* that the security agreement is a valid, binding and enforceable agreement of the borrower.

A remedies opinion covers the extent to which the courts will enforce each of the provisions of an agreement, including those that are unrelated to breach – notably a choice-of-law provision.[38] How then might the remedies opinion be affected in a transaction where the security agreement's governing law clause designates a law (*e.g.*, New York) that differs from, for example, the law designated by the Convention's Primary Rule (*e.g.*, England)?[39] Some may view such transactions as requiring no particular change to prior opinion practice; after all, enforceability opinions continue to be understood as being subject to mandatory

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[35] Of course a prudent lawyer would nonetheless file in Ontario with an eye toward possible proceedings in that jurisdiction, not to mention the need for filing in Ontario for transactions that also cover inventory, receivables or other collateral of a type not within the scope of the Convention.

In contrast to the Ontario example, UCC Article 9 deems many non-U.S. debtors to be located in the District of Columbia. *See* UCC § 9-307(c). Thus the change discussed in this paragraph would not apply to those debtors, nor to debtors that might separately be deemed to be located in the District of Columbia under § 9-307(f), (h), (i) or (j).

[36] Convention Art. 2(1)(f). *See also* Explanatory Report ¶ 2-28 ("For example, if, upon the default of a collateral provider, a collateral taker wishes to sell the collateral given to it by the collateral provider, the Convention law will determine whether it can do so and what conditions apply to the exercise of that power.").

[37] Under the UCC alone, the enforceability of such remedies provisions is determined simply by the agreement's general governing law clause (without constraint by, for example, a Qualifying Office requirement), so long as the transaction bears a reasonable relationship to the chosen law. *See* UCC § 1-301(a).

[38] *See* 1998 TriBar Report, *supra* note 13, at 620 & n.66, 621 (provisions that "choose the law by which the agreement is to be governed" are among those covered by the remedies opinion), § 4.4 at 634; Special Report of the TriBar Opinion Committee: The Remedies Opinion – Deciding When to Include Exceptions and Assumptions, 59 Bus. Law. 1483, 1495 (2004) (hereinafter "TriBar Report on the Remedies Opinion").

[39] It bears emphasizing that the Primary Rule (as well as the interpretive and first fallback rule) turns on provisions in the account agreement, not in the security agreement.

choice-of-law rules,[40] and those mandatory rules now include the Hague Securities Convention. Other firms may conclude that it is good practice to make explicit that the remedies opinion (or the opinion as a whole) does not cover the effect of mandatory choice-of-law rules. Still other firms may choose to adopt a specific roster of bodies of excluded mandatory choice-of-law rules, or may now adapt an existing roster to include the Convention.

C. A Word About Creation

The fundamental opinion point concerning creation of a security interest, *i.e.* that the security agreement creates a valid security interest in the securities account in favor of the lender, is not affected by the Convention. In other words, the creation of a security interest, strictly as between the debtor and secured party without regard to effects as against third parties, is not one of the issues listed in Convention article 2(1).[41] While the UCC does declare that a security agreement is generally effective against third-party purchasers and creditors, as well as between the parties,[42] for Convention purposes it is clearly proper to distinguish the agreement's effects between the parties (which are not covered) from its third-party effects (which are covered).

* * *

The Convention presents a certain number of isolated changes affecting opinion practice in intermediated securities transactions, but overall the Convention is remarkably consonant with the choice-of-law rules prevailing under the UCC alone. During this period in which U.S. lawyers are adjusting to the changes, it is helpful to keep in mind the benefits that the Convention is likely to bring over the long term. The recent U.S. ratification is expected to be followed by other ratifications. This prospective harmonization of choice-of-law rules across national borders should result in facilitating transactions, by greatly reducing legal uncertainty as well as the costs to the parties of

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[40] *See* 1998 TriBar Report, *supra* note 13, § 4.5 at 634; TriBar Report on the Remedies Opinion, *supra* note 31, at 1495 n.62 (subject to concerns about a possibly misleading opinion, "[a] remedies opinion does not require an exception for the possibility that the substantive law of a state whose law is excluded from the opinion by the coverage limitation might be applied to some aspects of the agreement as a result of a mandatory choice of law rule").

[41] The Convention covers "the . . . effects against the intermediary and third parties of a disposition of securities held with an intermediary," Conv. art. 2(1)(b), and while "disposition" is defined as including the grant of a security interest, Conv. art. 1(1)(h), in context the secured party itself cannot be understood as being one of the "third parties." *See also* Explanatory Report ¶ 2-9 (discussing the overlapping of various article 2(1) issues, notably the overlap of "effects against the intermediary and third parties" of a disposition with "the relevant perfection requirements, which are referred to in Article 2(1)(c)"). Cf. Conv. art 1(1)(i) (defining "perfection" as "completion of any steps necessary to render a disposition effective against persons *who are not parties to that disposition*") (emphasis added).

That the Convention does not cover the creation of a security interest as between the debtor and secured party is qualified by the separate point, discussed above, that the Convention does cover "the requirements, if any, for the realisation of an interest in securities held with an intermediary."

[42] UCC § 9-201(a).

investigation, negotiation and compliance with varying bodies of substantive law.

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NOTES FROM THE LISTSERVE

Including Explicit References to Customary Practice in Opinion Letters

[**Editors' Note**: Dialogues on the Committee's Listserve are not intended to be authoritative pronouncements of customary opinion practice, but represent the views of individual lawyers (and not their respective law firms) on opinion topics of current interest. Members of the Committee may review the comments referred to below by clicking on the "Archives" link under "Listserves" on the Committee's website.]

Including Explicit References to Customary Practice in Opinion Letters

It is widely accepted that third-party opinion letters are prepared and understood in accordance with the customary practice of lawyers who regularly give opinions and who review them for clients. Lawyers look to customary practice to identify the work (factual and legal) that opinion givers are expected to perform to give opinions. Customary practice also provides guidance and how certain words and phrases commonly used in opinions should be understood.

As noted in the *Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions*, 63 Bus. Law. 1277 (2008) ("Customary Practice Statement"), "[s]ome closing opinions refer to the application of customary practice. Others do not. Either way, customary practice applies." *Id.* at 1278.

In its report on *Cross-Border Closing Opinions of U.S. Counsel* (71 Bus. Law. 139, Winter 2015-2016) ("Cross-Border Report"), the Legal Opinions Committee notes that, in third-party opinion letters given by U.S. lawyers to non-U.S. parties ("Cross-Border Transactions"), where the non-U.S. opinion recipient is not represented by U.S. counsel and neither the recipient nor its counsel is familiar with U.S. customary practice, "the recipient runs a serious risk of misunderstanding an outbound opinion that is based on U.S. customary practice." *Id.* at 145. Accordingly, the Committee recommends "that opinion givers include in their third-party closing opinions an express statement that the opinions they are giving are intended to be interpreted in accordance with U.S. customary practice." *Id.* at 146.

By his email to the Listserve of April 12, 2017, Daniel H. Devaney IV of Cades Schutte LLP, Honolulu, asked whether it is reasonable to include an express statement referring to U.S. customary practice in a cross-border closing opinion letter *without* regard to whether (i) the recipient is represented by U.S. counsel and (ii) the recipient and its counsel are familiar with U.S. customary practice.

Stan Keller (Locke Lord LLP), who was a member of the editorial group that prepared the Cross-Border Report, responded that a fair reading of the Cross-Border Report's discussion of U.S. customary practice does not limit the recommendation to include an express statement