

International Swaps and Derivatives Association, Inc.
COLLATERAL LAW REFORM GROUP

AUSTRIA

COUNTRY REPORT

Supplement to
*Collateral Arrangements in the European Financial Markets:
The Need for National Law Reform*

March 2000

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Summary report on the legal framework for collateral arrangements for financial activity

Summary of the legal analysis under the laws of Austria applicable to collateral arrangements intended to secure financial trading activity in relation to privately negotiated derivative transactions, securities trading, securities repurchase transactions, stock lending and similar financial transactions in the wholesale financial markets. It is assumed that at least one of the parties involved is a financial institution (credit institution or investment firm) and that the collateral involved is cash, in euros or some other freely available currency, and/or fungible securities listed on a stock exchange or recognised market and held in immobilised or dematerialised form in a clearing system (“Fungible Securities”). References to “collateral” below indicate cash and Fungible Securities, unless otherwise specified.

This summary was prepared for the purpose of identifying possible areas of uncertainty or commercial impracticality arising under the laws of Austria in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in Austria and should not be relied on as such.

The position is stated as of December 1999.

This summary, prepared by the Collateral Law Reform Group, does not necessarily represent the views of ISDA or any of its members. It is a subjective assessment of the position in Austria and is simply intended to encourage debate and discussion of the relevant issues.

KEY POINTS FOR CONSIDERATION

- (1) The owner of a share in a pool of Fungible Securities would have absolute title to the assets.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is the place where the securities are physically held (subject to the law implementing Article 9(2) of the Settlement Finality Directive).
- (3) Conflicts of law rules would apply the *lex loci* to a holding or the transfer of, and perfection of a security interest in Fungible Securities and the express governing law of the agreement to the creation of such a security interest (subject to the law implementing Article 9(2) of the Settlement Finality Directive).
- (4) If security assets in which the owner has absolute title are held by a third party bank or custodian the security interest must be notified to the third party.
- (5) No official registration of a security interest with any state agency is necessary.
- (6) A pledgee may not use pledged assets as its own property.

- (7) Formal procedures apply to enforcement of a security interest but may be varied by agreement.
- (8) Enforcement of a security interest may be subject to one week's notice if no contrary agreement exists and may be stayed on insolvency.
- (9) Title transfer arrangements will not be recharacterised but are subject to a number of mandatory rules applying to collateral security.
- (10) Close-out netting under an ISDA Master Agreement is enforceable but doubts exist on the receivership of a credit institution.
- (11) Contractual set-off is enforceable on insolvency but doubts exist on the receivership of a credit institution.
- (12) Third party claims will normally not disrupt set-off and netting between solvent counterparties.
- (13) Top-up collateral will not be avoided as a preference if agreed in time.

1. Do the laws of Austria deal clearly with the nature of a participant's interest in a holding of Fungible Securities?

Yes, a clear characterisation of such interest is given in the Austrian Deposit Law (*Depotgesetz*).

2. How would such an interest be characterised under those laws?

Under the Deposit Law, such interest is characterised as an *in rem* co-ownership right in the pool of Fungible Securities held by the custodian ("pooled custody"). An *in rem* ownership right in specific securities kept separate from other securities is legally possible, but has become unusual. A custody agreement where, upon giving securities into custody, the depositor's *in rem* ownership right is lost, requires a special written authorisation by the depositor.

3. How would the location of Fungible Securities be determined under the laws of Austria?

Under Austrian law as currently in force, the location would be determined according to the *lex rei sitae* (or *lex cartae sitae*) rule. That is the laws of the place where the certificates are physically held. There is no rule of Austrian law that the location of Fungible Securities held in an account with a clearing system would be the place of the account. The provision in the law implementing Article 9(2) of Directive 98/26/EC of May 19, 1998 (the "Settlement Finality Directive") does not depart from this basic rule in our view due to its limited scope.

4. Under Austria's conflict of laws rules, what law would govern:

(a) the characterisation of a person's holding of Fungible Securities?

The characterisation of a person's holding of Fungible Securities (that is, the legal nature of such holding) would be governed by the *lex situs*, that is, the law of the location of the Fungible Securities.

(b) the creation of a security interest in cash or Fungible Securities?

The creation of a security interest in cash or Fungible Securities (that is, the pledge agreement between the parties creating the security interest) would be governed by the law chosen by the parties to govern the pledge, subject to the conflicts of laws rules of the Rome Convention.

(c) the formal validity or perfection of a security interest in cash or Fungible Securities?

The formal validity or perfection of a security interest in cash or Fungible Securities would most likely be governed by the laws of the location of the cash or Fungible Securities (*lex rei sitae*). With regard to Fungible Securities held in a "system" this principle will be (partly) modified by implementation of Article 9/2 of the Settlement Finality Directive as of December 10, 1999.

(d) the effectiveness and formal validity of a transfer of title to Fungible Securities?

The effectiveness and formal validity of a transfer of title to Fungible Securities is likely to be governed by the *lex cartae sitae*. The Austrian Supreme Court has ruled in one case that the law of the place of the issuing company's central administration should apply to the validity of a transfer of title in certificated securities which were bearer shares (cf. OGH IPRF. II/54) but we doubt that this decision adequately reflects the law.

5. What types of security interest may be created under the laws of Austria in:

- (a) cash?**
- (b) Fungible Securities?**

Where more than one type of security interest is possible, please indicate which type(s) would typically be used for collateral arrangements involving cash and/or Fungible Securities, and why.

- (a) (Physical) cash may be pledged as collateral. Typically, however, cash is held in the form of a claim for cash against a bank. In this case, the claim for cash is pledged or, alternatively, assigned as security. Both arrangements are widely used, although in some cases, assignments are subject to stamp duty.
- (b) A security interest in Fungible Securities can be provided by pledging the securities as collateral.

Alternatively, legal title to either cash or Fungible Securities could be transferred with an obligation on the transferee to use such cash only as provided by the agreement. This is discussed further under Question 9(a). Both forms of arrangement are widely used.

6. In relation to each of these types of security interest, describe briefly any filing, registration, notification, notarisation or other formal requirement necessary to ensure validity of (or "perfect") the security interest? In relation to each type of security interest, please indicate the consequence of failing to comply with the relevant requirement.

Only security interests in real estate (immovable property) need to be registered under Austrian law in order to be valid. As for security interests in other property (including cash, Fungible Securities and contractual claims thereto), no filing is necessary. Perfection is achieved by what is called "publication" (*Publizität*). Publication is achieved by (physical) transfer of the assets subject to the security interest to the secured party, or (if a claim is pledged or assigned as security) by informing the claim's third party debtor of the pledge and/or marking the pledge in the pledgor's books. With regard to Fungible Securities, publication is usually achieved by transfer of the interest in Fungible Securities in the books of the custodian. If publication is not achieved, the pledge is invalid vis-à-vis third parties for lack of perfection.

- 7. In relation to each type of security interest, indicate whether the collateral receiver is entitled to use the collateral as though it were the absolute owner of the collateral, including the right to sell, lend or re-pledge (rehypothecate) the collateral to a third party.**

If an asset is merely pledged as collateral (without title being passed), the collateral receiver is not entitled to use the collateral as though it were the absolute owner. If title to the asset is transferred to the collateral receiver, the collateral receiver is – in relation to third parties – entitled to use the collateral as though it were the absolute owner of the collateral, although he may be contractually bound under the security agreement and/or by mandatory law not to use the asset in certain ways. This is discussed further under Question 9(a).

- 8. Briefly describe the enforcement procedures for each type of security interest commonly used for collateral in relation to financial activity. For example, is court approval required before the security interest may be enforced and/or is some form of auction procedure required. Indicate any practical difficulties typically encountered and also the relative efficiency and speed (or lack of same) of such procedures. Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

The parties may freely agree enforcement procedures in the pledge agreement (subject to certain equitable requirements). For instance, if mutually agreed by the parties, no court approval is required before the security interest may be enforced. In the absence of such an agreement, commercial parties may under certain conditions sell collateral held without court approval after giving one week's prior notice to the collateral provider, under Sec. 368 of the Austrian Commercial Code (*Handelsgesetzbuch*) and Article 8 subpara 14 and 15 of the Introductory Decree to the Commercial Code. Under these provisions, securities which have a market or exchange value, and bank savings certificates need not be sold by auction. In all other cases, the enforcement of a security interest may only be effected through the court. If the collateral provider is subject to formal insolvency (bankruptcy or composition) proceedings, there is a 90 day freeze on the sale of the collateral if (amongst other conditions) an immediate sale would otherwise put at risk a possible restructuring of the insolvent's business.

- 9.a. In relation to local law collateral arrangements based on transfer of title, please indicate whether there is a risk that the courts of Austria would recharacterise the transfer of title as the creation of a form of security interest? If so, please give some indication of the degree of that risk (for example, very low, low, medium, high, very high). Please indicate the consequences of such a recharacterisation.**

A transfer of title in order to provide security is a specific type of transaction under Austrian law called a "*Sicherungsübereignung*" (a transfer of ownership with certain restrictions

described below). Whether the transaction is characterised as an outright sale and transfer of ownership or a *Sicherungsübereignung* depends on the purpose of the transaction, rather than whether a right to use the assets is agreed or not. A repo, where the transferee must return the asset at a certain date, or at a date to be specified by the transferor would most likely be regarded as being similar to a *Sicherungsübereignung*. However a transaction where the transferee has merely the option to return the asset would most likely be regarded as an outright sale combined with a put option granted in favour of the transferee.

While in a *Sicherungsübereignung* the transferee becomes the legal owner of the asset, a number of restrictive provisions apply to the relationship between the transferor and the transferee (many of which will also apply to a pledge of collateral). These include: (i) the transfer must be perfected by delivery of the asset to the transferee or his agent; (ii) the transferee may only exercise rights of ownership to the extent agreed between the parties or as necessary to support the priority of his claim; (iii) the transferee's ownership is contingent on the validity of the claim; (iv) even if the parties have agreed that the transferred assets may be sold by the transferee without court proceedings any sale may only be effected by the transferee at a market or quoted price (or at the independently assessed value of the asset) and any agreement between the parties to the contrary will be void; (v) any agreement that the transferee be allowed to keep the asset regardless of any excess in value of the asset over the transferee's claim will be void; (vi) use of the asset may be enjoyed by the transferee only to the extent authorised by the transferor and in any case only in a manner not harmful to the interests of the transferor; and (vii) the parties may only validly agree that the transferee has a right of *usufruct* if separate consideration is given for this. However the transferee may pledge the asset to a third party with or without the transferor's consent.

Further restrictions may be imposed by agreement between the transferor and the transferee. If the transferee disposes of the asset to a third party in violation of the above provisions or any additional contractual restrictions, the transferee will become liable to the transferor in damages, although the disposal will not be set aside so long as that third party was acting in good faith. Assets held by a transferee under a *Sicherungsübereignung* will be available to the transferee's creditors only on execution of the transferee's claim against the transferor (subject to the legal restrictions mentioned above and any other restrictions agreed between the parties). To the extent the transferor discharges its obligations to the transferee, the assets will not be available to the transferee's creditors.

It is not clear under Austrian law what status an agreement would have that allowed the transferee to sell or on-lend securities received under a *Sicherungsübereignung* prior to any default by the transferor and which would replace the claim of the transferee to the securities with a claim to the proceeds of sale or for equivalent securities. In our view such an agreement would be valid provided that the transferor has the right to receive equivalent securities at maturity, and that the transferee accounts for the securities at their current market price should the transferor default (and that the transferor has given its express prior agreement that this should be the case). However we are not aware of any settled case-law or published academic views on this point.

On the other hand, if the securities transferred are Fungible Securities there will be no obligation for the transferee to return the self-same securities at maturity under Austrian law. If the transferor defaults and the transferee has not sold or lent the assets the transferee should sell the assets at their current market price (unless required to sell through a court procedure) and apply the proceeds in satisfaction of the transferee's claim. If the transferee has sold or lent the assets the notional market value at the time of default should be applied in satisfaction of the claim.

- 9.b. If the agreement is governed by a foreign system of law that does not recharacterise, would the risk of recharacterisation under domestic law still be present?**

There is no risk under domestic law. However, *lex situs* restrictions as summarized under the answer to Question 9.a. above would apply.

- 10. Is close-out netting, for example, under a 1992 ISDA Master Agreement, enforceable under the laws of Austria? If so, but subject to certain limitations (for example, as to the nature of the counterparty or types of transaction included within the netting), please indicate briefly what those limitations are.**

Outside the context of insolvency, close-out netting may be freely agreed between the parties and would be enforceable under the laws of Austria. Under the Bankruptcy and Debt Recomposition Codes, special provisions explicitly allow for the enforceability of close-out netting agreements in bankruptcy and/or debt recomposition proceedings in relation to claims resulting from securities lending, repurchase agreements, as well as certain options, swaps, futures and forward agreements. In any case not covered by these provisions, the enforceability of close-out netting on insolvency is doubtful in light of previous decisions by the Austrian courts. There are no express provisions with regard to the enforceability of close-out netting in the case of proceedings under the special receivership regime (*Geschäftsaufsicht*) for credit institutions. Legislation to clarify this would be desirable, although in principle close-out netting should be enforceable in such proceedings.

See also the netting opinions provided to ISDA by Schönherr Barfuss Torggler & Partner of November 1998, February 1999 and May 1999.

- 11. Is contractual set-off and/or insolvency set-off enforceable in the event of formal insolvency proceedings in the courts of Austria in relation to a counterparty organised in Austria? Please indicate the answer in relation to each type of formal insolvency proceeding (including rehabilitation or reorganisation proceedings such as administration or *redressement judiciaire*) possible in Austria in relation to a corporate entity (including a financial institution). Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

Special mandatory provisions apply with regard to set-off in bankruptcy and debt recomposition proceedings. Notably, claims not due at the time of bankruptcy or a debt recomposition may be set off. However, no claims may be set off which arose only after the commencement of the bankruptcy or debt recomposition proceedings, or within the preceding six months (subject to certain exceptions). These provisions are mandatory.

Credit institutions are not subject to debt recomposition proceedings. Instead, a special receivership regime applies under the Austrian Banking Act (*Bankwesengesetz*). However, there are no rules in relation to set-off in the receivership of a credit institution, and we are not aware of any settled case law in this regard. There are no other rules under Austrian law which would permit the courts to freeze or otherwise prevent or delay the enforcement of rights of set-off against a party subject to formal insolvency proceedings.

- 12. Would the exercise of netting or set off rights under a title transfer collateral arrangement be vulnerable to the rights of third parties in the event of the insolvency of the collateral giver? For example, would it be possible for the collateral giver to disrupt (deliberately or inadvertently) the netting or set-off by assigning to a third party creditor its right to redelivery of equivalent collateral under the collateral arrangement?**

Could that right to redelivery be attached by a third party creditor of the collateral giver free of the collateral taker's netting or set off rights under the collateral arrangement?

It is generally accepted under Austrian law that if a claim is assigned, the debtor of the claim may nevertheless set off against his obligation to the assignee any eligible claims against the assignor provided that these arose prior to the moment when the debtor was informed of the assignment. If an obligation which arises only in the future is assigned, the courts have held that set-off is possible in relation to any claims of the debtor against the assignor which arose earlier in time than the date the assigned obligation becomes due (rather than only those arising prior to the moment when the debtor was informed of the assignment as would be the case for other claims). These rules will therefore protect the collateral taker from any disruption of his rights of netting being caused by an assignment by the collateral giver to a third party of rights to redelivery of the collateral, or by any attachment by a third party of such rights.

- 13. In relation to mark-to-market collateral arrangements, is there any risk under the preference (or similar) rules of Austria that “top-up” deliveries of collateral would be vulnerable to avoidance if made during a relevant period prior to the insolvency of the collateral giver?**

Previous decisions of the Austrian courts suggest that, if at the time any mark-to-market collateral arrangement was agreed, no preference existed, then subsequent "top-up" deliveries of collateral are not subject to avoidance, either. However, we would not fully exclude the risk of a "top-up" being vulnerable to avoidance.

- 14. Please add any additional comments on the general legal framework for collateral arrangements under the laws of Austria, whether based on creation of a security interest or on title transfer, highlighting any difficulties that should be addressed in any project for collateral law reform in Austria.**

In our view, the rules for the special receivership regime applying to credit institutions (as outlined in our answer to Question 11. above) should contain clear provisions on set-off. Also, the Bankruptcy and Composition Codes should, in light of certain precedent decisions by Austrian courts, be amended so as to clarify rights of set-off on insolvency other than under the special provisions mentioned in our answer to Question 10 above. Finally, in our view the proposed provisions implementing the Settlement Finality Directive into Austrian law falls partly short of the provisions and/or intentions of the Directive.

The Collateral Law Reform Group acknowledges the assistance of Bruckhaus Westrick Heller Löber, Vienna in the preparation of this report. That firm, however, accepts no liability in relation to this report.