

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

DENMARK

COUNTRY REPORT

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

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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 Denmark 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 Denmark in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in Denmark 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 Denmark 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 an uncertain interest in the assets.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is the place where the account is held.
- (3) Conflicts of law rules would apply Danish law to a holding or the transfer of Fungible Securities and the creation and perfection of a security interest in Fungible Securities.
- (4) If security assets are held by a third party bank or custodian the security interest must be notified to the third party and registered on the account.
- (5) No official registration of a security interest with any state agency is necessary.
- (6) A pledge may not use pledged assets as its own property.
- (7) Formal procedures apply to enforcement of a security interest.

- (8) Enforcement of a security interest may be delayed by one week.
- (9) Title transfer arrangements may be recharacterised to the extent Danish law is the applicable law.
- (10) Close-out netting under an ISDA Master Agreement is enforceable.
- (11) Contractual set-off is enforceable on insolvency.
- (12) Third party claims will not disrupt set-off and netting between solvent counterparties in the case of simple debt obligations.
- (13) Top-up collateral may be avoided as a preference if transferred within six months of insolvency.

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

Not entirely; see below.

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

Whether it is possible to assert ownership over securities which are held on a co-mingled basis depends on whether the owner is able to identify the relevant securities and prove ownership of them. The Danish Securities Trading Act Section 6, Section 6(3) provides that a securities dealer is entitled to keep the securities of its clients in an omnibus account or a segregated account. However, section 6(3) further provides that the securities dealer shall keep a register clearly identifying the individual client's rights of ownership of the relevant securities. These provisions are intended to ensure that an owner will be able to prove his ownership to securities kept on a co-mingled basis and enable each owner to reclaim any securities held in a mingled account in the event of the securities dealer's bankruptcy.

The interest created in mingled securities held in a segregated client account would not be a direct right to any individual assets held in the account. Rather, the owner would be considered as having an ownership interest in securities equal to his/her part of the total amount of securities registered in the account. Such an interest will include all the normal incidents of ownership in any other respect..

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

Dematerialised securities (such as any Fungible Securities registered with the Danish Securities Centre ("DSC")) will be deemed located in the jurisdiction of the institution with which the holding of such securities is registered under Danish law.

Where securities are held in certificated form (including immobilised securities) it is necessary to distinguish between negotiable and non-negotiable securities under Danish law. The location of negotiable securities will be deemed to be the physical location of the securities, irrespective of the location of the debtor (debt instruments) or the company (shares). Non-negotiable securities will be deemed to be located where the debtor has its residence/domicile.

4. Under Denmark's conflict of laws rules, what law would govern?

- (a) **the characterisation of a person's holding of Fungible Securities?**
- (b) **the creation of a security interest in cash or Fungible Securities?**
- (c) **the formal validity or perfection of a security interest in cash or Fungible Securities?**
- (d) **the effectiveness or formal validity of a transfer of title to Fungible Securities?**

In all the cited situation (a) - (d) it appears that Danish law would most likely be the governing law.

5. What types of security interest may be created under the laws of Denmark 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.

Under Danish law there are basically very few types of security interest available. In respect of cash, a security interest will have to be created by either (i) physical possession of the cash or (ii) obtaining a pledge of a bank account with the cash deposited in such account. In respect of Fungible Securities a security interest may be created by simple pledge agreement between the pledgor and pledgee.

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 the validity of (or "perfect") the security interest? In relation to each type of security interest, please indicate the consequences of failing to comply with the relevant requirement.

A pledge of a bank account is perfected by notification of the pledge to the bank with which the account is held. With respect to a security interest over Fungible Securities the measures required to perfect such a security interest are registration of the pledge with the DSC. In practice this means registration must be carried out by a so-called DSC-Account Institution. Most Danish banks and savings banks are DSC-Account Institutions, and so are able to register transfers and security interests directly for individual clients with the DSC.

The consequence of failing to comply with the relevant perfection requirements is that the security interest will not be effective vis-à-vis the pledgor's creditors. The security interest will still be valid as between the pledgor and the pledgee although, for obvious reasons, this may not be much help.

- 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.**

It is possible to a certain extent to re-pledge (rehypothecate) any collateral received to a third party. However, applicable Danish law in this respect is not based on any statutory provisions. The circumstances under which such a re-pledge may take place and the conditions which would apply are thus not entirely clear. A broader right of the pledgee to use the collateral, for example, to sell or lend it, is not possible.

- 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.**

With respect to the enforcement of a security interest in Fungible Securities registered with the DSC there are certain statutory provisions contained in sections 538a and 557 of the Danish Administration of Justice Act. These provisions basically provide that before any enforcement is effected the debtor shall have a "grace period" of one week to fulfil its obligations, and that a security interest in Fungible Securities may only be enforced by a sale of such securities through a bank or a member of the Copenhagen Stock Exchange.

- 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 Denmark 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.**

Collateral arrangements in Denmark are not based on transfer of title. It is difficult to predict the result if such an arrangement were to be considered under Danish law since, to our knowledge, Danish courts have not dealt with this specific situation. We believe, however, that as between the parties a Danish court would be inclined to recharacterise the arrangement as the creation of a form of security interest on the basis that this was the true intention of the parties. *Vis-à-vis* the creditors of the pledgee, however, it is unlikely that such an arrangement would be enforceable, since the parties would have neglected to perfect the security interest in the manner required under Danish law.

- 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?**

Were a Danish court to review arrangements based on the transfer of title under a foreign law it is likely the Danish court would uphold the arrangement since it does not appear to be against Danish *ordre public* or contravene any mandatory protective rules of Danish law.

- 10. Is close-out netting, for example, under a 1992 ISDA Master Agreement, enforceable under the laws of Denmark? 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.**

Close-out netting is enforceable under Section 57 and 58 of the Danish Securities Trading Act. An extract of the specific wording of these two Sections of the Danish Securities Trading Act is attached hereto.

See also the netting opinions provided to ISDA by Gorrissen Federspiel Kierkegaard of December 1997 and November 1998.

- 11. Is contractual set-off and/or insolvency set-off enforceable in the event of formal insolvency proceedings in the courts of Denmark in relation to a counterparty organised in Denmark? 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 Denmark 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.**

Generally, contractual set-off is enforceable in the event of formal insolvency proceedings. There is no possibility of a stay or freeze in the event that the collateral provider is subjected to formal insolvency proceedings of any type. There are also not the same number of different formal insolvency proceedings under Danish law as there are, for example, under English law. However, contractual set-off is limited by a number of protective provisions in the Danish Bankruptcy Act, inter alia, Section 42(3) and 42(4), as a result of which contractual rights of set-off may not be exercised (i) in circumstances where the creditor has acquired the claim from a third party within the 3 months prior to the insolvency or in circumstances where the creditor had reason to suspect insolvency, or (ii) where the contractual set-off includes payments which may be avoided by the bankruptcy estate.

- 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?**

Third party claims will not disrupt set-off and netting between solvent counterparties in the case of simple debt obligations. An obligation to return equivalent collateral under a title transfer arrangement should normally be treated as a simple debt obligation, depending on how the obligation is worded. It is less clear how these issues may be dealt with under Danish law in relation to other classes of asset, for example, negotiable instruments.

- 13. In relation to mark-to-market collateral arrangements, is there any risk under the preference (or similar) rules of Denmark 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?**

Yes, based on the principle that "new security for old debt" may be avoided, any additional deliveries of collateral might be vulnerable to avoidance if made within 6 months prior to the insolvency of the entity providing the collateral.

- 14. Please add any additional comments on the general legal framework for collateral arrangements under the laws of Denmark, 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 Denmark.**

The following points in particular raise possible concerns: -

- *Nature of Participant's Interest.* The nature of a participant's interest in a holding of Fungible Securities is not entirely clear.
- *Enforcement.* A delay of one week must elapse before a security interest can be enforced.
- *Transfer of title.* Transfer of title collateral arrangements are not enforceable under Danish law.
- *Insolvency Set-off.* Insolvency set-off is not available in respect of claims arising up to 3 months prior to insolvency.
- *Preferences.* Preference avoidance rules may apply to deliveries of top up collateral.

The Collateral Law Reform Group acknowledges the assistance of Kromann & Münter, Copenhagen in the preparation of this report. That firm, however, accepts no liability in relation to this report.

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APPENDIX

Part 18

Netting

- 57.-(1) An agreement between two or more parties to the effect that all proved claims pertaining to the clearing business carried on by a clearing centre or Danmarks Nationalbank, cf. section 50 (3) of this Act, or pertaining to a payments system which is settled through accounts with Danmarks Nationalbank, shall be set off against each other (netted), may with legal effect towards the estate and creditors also include a provision to the effect that such claims shall be finally discharged or reversed in full if one of the parties is ordered to be wound up, or an administration order is applied for, or negotiations for a compulsory composition are opened. However, such agreement shall, in order to have any legal effect towards the estate and the creditors to be submitted to the Supervisory Authority before winding-up, administration order or negotiations for a compulsory composition have occurred and shall contain objective conditions pertaining to the cases in which proved, but not yet satisfied claims shall either
- 1) be satisfied in accordance with the netting agreement or
 - 2) be reversed in full.
- (2) The Supervisory Authority shall be entitled to approve that agreements on netting with foreign clearing centres or corresponding foreign enterprises will have legal effect pursuant to subsection 1 hereof.
- (3) The Supervisory Authority shall draw up a list of the clearing and settlement systems to which netting may apply with legal effect pursuant to the provisions laid down in subsections 1 and 2 hereof. Such list shall be published by executive order.
58. An agreement between two or more parties to the effect that all their claims against one another which result from foreign-exchange and securities trading under this Act shall be set off against each other (netted) regularly or if one party violates his contractual obligations, may also with legal effect towards the estate and creditors contain a provision to the effect that the claims concerned shall be finally discharged if one of the parties is ordered to be wound up, or an administration order is applied for, or negotiations for a compulsory composition are opened, or dies.