

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

FRANCE

COUNTRY REPORT

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

March 2000

European Office:
International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
Telephone: +44 171 330 3550
Fax: +44 171 330 3555

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

FRANCE

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

Summary of the legal analysis under the laws of France 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 held listed on a stock exchange or recognised market and 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 France in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in France 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 France 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 may have absolute title to or an indirect interest in the assets.
- (2) The *lex loci* of French dematerialised securities will be French law and of rights to Fungible Securities held through an account in a clearing system will be the place where the account is held.
- (3) Conflicts of law rules would apply the *lex loci* to the transfer of Fungible Securities and perfection of a security interest in Fungible Securities and the governing law of any agreement to the creation of such a security interest and a holding of Fungible Securities.
- (4) If security assets are held by a third party bank or custodian the security interest must be notified to or acknowledged by the third party.
- (5) A pledge of a bank account must be officially registered and a pledge of Fungible Securities in practice is usually officially registered with local tax authorities.
- (6) A pledgee party may not use pledged assets as its own property, subject to limited exceptions.
- (7) Formal procedures apply to enforcement of a security interest.
- (8) Enforcement of a security interest will not be delayed under a commercial pledge but is stayed on insolvency.

- (9) Title transfer arrangements will not be recharacterised so long as the arrangements fall within relevant legislation.
- (10) Close-out netting under an ISDA Master Agreement where one of the parties is a financial institution is enforceable.
- (11) Contractual set-off is only enforceable on insolvency for connected obligations. Close-out netting is governed by separate statutes.
- (12) Third party claims will not disrupt set-off and netting in relation to specified derivative transactions between solvent counterparties but may do so in relation to other transactions such as securities repurchase (repo) transactions and securities loans.
- (13) Top-up collateral may be avoided as a preference.

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

Yes. Act no. 81-1160 dated 30th December, 1981 relating to the *dématisation* of securities provides that securities accounts are opened "in the name of the owner" of such securities. The owner of Fungible Securities (dematerialised securities) is the beneficiary of a traceable property right over the securities even in fungible form, such a right being a right *in rem (droit réel)* as opposed to a personal right against the clearing system (*droit de créance*) in respect of the securities.

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

French law recognises in respect of Fungible Securities various categories of rights which may exist under the Civil Code in respect of other moveable assets.

Broadly, there exist two categories of rights *in rem*:

- Principal rights *in rem (droits réels principaux)* which give the holder the power to benefit directly from the asset. The extent of the right may vary depending on the exact nature of the right. Full ownership (*pleine propriété*) is the most absolute right including the right to use (*usus*), enjoy the benefits (*fructus*) and dispose (*abusus*) of the asset to the fullest extent permitted by law (Article 544 of the French Civil Code). Lesser rights may be established such as the stripping of the right to use and enjoy the benefits of the assets (*usufruit*) from bare ownership (*nue-propriété*).
- Ancillary rights *in rem (droits réels accessoires)*, such as pledges or mortgages, which only give the holder contingent rights over the assets, mainly for security purposes. The general rule is that the beneficiary should be given possession, actual or constructive, of the assets to which such rights relate.

All of these rights may be created in respect of Fungible Securities.

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

The main feature of dematerialised securities being that they are held in book-entry form, the location of the “book” will be the key criterion for determining the location of Fungible Securities. This will often coincide with the jurisdiction of the issuer.

Fungible Securities may also be subject to subsequent custody arrangements which may make this criterion difficult to apply. For instance, French Treasury bonds may be held in Euroclear or Cedelbank, each of which maintains its own book-entry system. Yet, the bonds themselves will always be deemed located in France (where the register in respect of the issue is maintained) and the accounts maintained in the context of such subsequent custody arrangements will only evidence personal rights in respect of the securities. Therefore a security interest in such rights perfected in accordance with the rules of the relevant central depository would be ineffective to grant to the secured party a right *in rem* in respect of the securities themselves.

4. Under French conflict of laws rules, what law would govern:

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

Characterisation is always made by French courts in accordance with the laws of France.

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

By creation, we mean the agreement of the parties to enter into the relevant security agreement.

As a matter of principle, French law recognises the right of the parties to a contract to provide that their agreement be governed by any freely elected law provided that:

- (i) such agreement is an international agreement; and
- (ii) such election is not intended to avoid the application of any mandatory provisions of French law which would have otherwise applied to such agreement.

Where the agreement is not an international contract (for example, both parties are French entities and the eligible collateral would only be located in France), the governing law must be French law.

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

The governing law is the law of the jurisdiction of the place where the assets are located.

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

The governing law is the law of the jurisdiction of the place where the assets are located.

5. What types of security interest may be created under the laws of France in cash or Fungible Securities?

The main types of security interest (leaving aside the various legal regimes allowing for transfer of title) are:

(a) With respect to Cash

- (i) The *gage-espèces* is a pledge of cash. The creditor is given possession of the pledged cash by transfer to an account opened in the name of the creditor or a third party. When the account is opened with the creditor itself, the resulting arrangement is similar to a transfer of title arrangement: because of the fungible nature of the asset, the creditor becomes the owner of the pledged sums and may enforce its rights by way of set-off.

As a result of its simplicity and efficiency (including in an insolvency context), this is the most commonly used type of security interest over cash.

- (ii) Alternatively, a pledge may be created over a bank account (in which case the account should be blocked, failing which the creditor runs the risk of the account being debited) or, more frequently, over the credit balance of a bank account ("Cash Account Pledge").

The pledge does not technically relate to the cash itself but, rather, to the contractual claim of the pledgor against the bank with which the account is held. Accordingly, the pledge must comply with the requirements of French law relating to pledges of claims (Article 2078 Civil Code).

(b) Fungible Securities

There is only one method of creating a pledge over Fungible Securities, which is a pledge of a financial instruments account ("Securities Account Pledge").

A uniform regime for this is laid down by Article 29 of Act no. 83-1 dated 3rd January, 1983 (as amended) concerning the granting of pledges over securities accounts in which financial instruments are held.

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.

(a) *Gage-espèces*

A *gage-espèces* simply requires that cash is transferred to an account opened in the name of the creditor or a third party. The transfer should specify that it is made by way of security. There is no formal requirement necessary to ensure the validity of the security interest other than the transfer. In the absence of transfer, with the debtor retaining possession, the pledge is invalid.

It is common for a *gage-espèces* also to be evidenced in more detail in a separate agreement between the pledgor and the secured party.

(b) Cash Account Pledge

- **Agreement:** a written agreement should be executed either in notarised form or as a private agreement which is subsequently registered with the local tax administration. The agreement should specify the amount of the secured liability or other relevant details to allow its identification, and sufficient details to identify the relevant account in which the cash is held.
- **Notification:** the pledge agreement must be formally notified by a process server (*huissier*) to the bank with which the relevant account is opened, or formally accepted by the bank in a notarised pledge agreement.
- **Language:** a notarised pledge agreement must be drafted in French and a private pledge agreement, even if drafted in a foreign language, must be translated in order to be registered.

(c) Securities Account Pledge

- **Filing:** a declaration (*déclaration de gage de compte d'instruments financiers*, the "Declaration") must be signed by the pledgor who must be the person in whose name the securities account is opened; the pledge is perfected as of the date of the execution of the Declaration.
- **Notification:** the Declaration must be filed with the person with whom the securities account is held (the "custodian"). If the Declaration is not filed, the pledge will not be perfected, whether as between the parties or *vis-à-vis* third parties. The custodian will issue the secured party with a certificate (*attestation de constitution de gage*) evidencing the pledge. However even if no certificate is issued, the pledge will nevertheless be validly perfected.

No notarisation or other formal requirements are necessary to perfect a Securities Account Pledge.

- **Registration:** because it is very important that the date of execution of the Declaration cannot be challenged, it is common practice (but not a legal requirement) to have the Declaration registered with the local tax administration to show the date of filing.

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.

(a) General

Although the pledgor is required pursuant to Article 2076 of the French Civil Code to surrender legal possession of the relevant collateral to the secured party or a third party custodian the pledged assets remain the property of the pledgor. Thus, under Article 2078 of the French Civil Code a the secured party cannot use, sell or otherwise dispose of the pledged assets. On the contrary, use or disposal by the secured party is so inconsistent with the nature of the security interest granted to the secured party that French law makes it a specific criminal offence if a secured party

disposes of pledged assets (Article 314-5 of the French criminal code). Accordingly, security interests perfected under French law will only grant the secured party a right to retain the assets.

(b) *Gage-espèces*

However, because of the fungible nature of cash, the collateral receiver under a *gage-espèces* becomes the owner of the funds and may use them as though it were the absolute owner, subject only to its contractual obligation to return the relevant sum once the secured obligation is discharged.

(c) Cash Account Pledge

The general rule in (a) above applies to the Cash Account Pledges.

(d) Securities Account Pledge

The general rule in (a) above applies to Securities Account Pledges.

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.

(a) General

Under Article 2078 of the French Civil Code, if a debtor defaults in the payment of any secured obligation, a secured party may apply to the court in order either (i) to obtain title to the pledged assets as partial or full payment (subject to valuation of the assets by an expert), or (ii) to request that the pledged assets be sold by public auction. The procedure is simplified if the pledge is a commercial pledge, to the extent that, after making a formal demand to the debtor, the secured creditor may directly procure the sale by public auction of the pledged assets without being required first to obtain a court decision approving the sale.

As a result of Article 2082 of the French Civil Code, a debtor which has surrendered possession of collateral to its secured creditor cannot claim repossession of the pledged assets until after payment in full of the secured liability. This right of retention is, in practice, a very important protection for the secured creditor.

If a debtor is subject to insolvency proceedings, enforcement proceedings initiated by a creditor (*voies d'exécution*), and, more generally, individual judicial proceedings initiated by a creditor relating to pre-insolvency claims are stayed.

(b) *Gage-espèces*

A creditor is entitled, in the event of a default by the debtor, to set off sums owed to it against any sum it owes to the debtor with respect to the *gage-espèces* (namely its obligation to return the funds transferred to it). No court approval is required.

(c) Cash Account Pledge

If the secured party is a bank and the pledged account is held with that bank, the bank will be entitled, if the pledgor defaults, to set off the sums owed to it by the pledgor against the sum standing to the credit of the pledged account at that time. A prerequisite to enforcement is that the bank claim's against the pledgor should be certain in its principal, liquidated in its amount and due and payable (*certain, liquide et exigible*).

If the secured party is not the bank with whom the pledged account is held, enforcement should be effected in the ordinary way (Article 2078 Civil Code).

(d) Securities Account Pledge

The secured party may enforce its rights without court proceedings with respect to pledged assets which may be valued independently, for example, securities which are listed on a regulated market. A prerequisite to enforcement is that the secured party's claim against the pledgor should be certain in its principal, liquidated in its amount and due and payable.

- The first step in the procedure is a formal written demand on the debtor which may be delivered in person or by registered mail (*courrier recommandé*);
- for a sum denominated in any currency and held in a financial instruments account (for example, coupon payments), enforcement would be effected by an outright transfer of title to such sum, up to the value of the secured liability, in favour of the party benefiting from the security; and
- in respect of French or foreign securities which are traded on a regulated market the secured party is allowed to procure the sale of such securities in that market or even, contrary to traditional principles governing security interests, to appropriate an amount of such securities adequate to cover the secured liability on the basis of the last available closing price of such securities in the relevant market.

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 France 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) General

As a general matter, one should stress that transfer of title by way of security is a recent but well established concept under French law. French legislation provides for several types of arrangement which rely on this approach and which are relevant for our purposes :-

Paragraph 4 of Article 52 of Act no. 96-597 dated July 2, 1996 implementing in France the EU Investment Services Directive (the "1996 Act"): this legislation is specifically dedicated to the collateralisation of "transactions on financial instruments" including derivatives transactions.

Article 33 of the Act dated June 17, 1987, as amended, on securities lending (the "1987 Act"): along the same lines, the 1996 Act has amended the legal provisions governing securities loans contained in a 1987 statute, introducing provisions allowing the parties to collateralise their exposure by arrangements based on a transfer of title.

Article 12-Vbis of the Act dated December 31, 1993, as amended, on repurchase transactions (the "1993 Act"): this law has clarified the legal regime relating to repurchase transactions and contains provisions allowing the parties to collateralise their exposure by arrangements based on a transfer of title.

Collateral arrangements based on a transfer of title and relating to securities may only be structured in accordance with the above legislation and provided that the relevant conditions for its application are met. With respect to cash, the technique of the *gage-espèces* is always generally available as an alternative.

(b) Recharacterisation

Any purported transfer of title which does not comply with the conditions applicable to the relevant regime would be recharacterised as an invalid sale or an invalid pledge.

Also, because such legal regimes have been established to allow the collateralisation of specific types of transaction, the question of characterisation also arises in relation to the secured transaction. In that context, two principles should be borne in mind:-

- (i) French courts when ruling on any agreement are obliged to characterise the agreement in accordance with French law; and
- (ii) French courts are never bound by the characterisation given by the parties to their agreement, and the courts are always free to recharacterise the agreement.

Thus, taking the example of a securities loan, if a French court were to determine, based on all circumstances of the case, that the real intention of the parties was effectively to lend cash on a secured basis, the regime of the 1987 Act would not apply. The transfer of the "loaned securities" could then be recharacterised as an invalid pledge.

On the contrary, to the extent that the intention of the parties is effectively to secure the underlying transaction and that the parties comply with the conditions applying to one of the above-referred methods, there is no risk of recharacterisation of the arrangements as an invalid pledge.

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

The fact that an agreement is governed by a foreign legal system which does not recharacterise would not affect the approach of a French court, which is to determine the real intentions of the parties, regardless of the governing law, and characterise these using French legal categories.

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

The enforceability of termination and close-out netting agreements has been the subject of various pieces of legislation. There is currently no unified regime and there exist separate provisions dealing with close-out netting in the 1996 Act (in relation to derivatives), the 1987 Act (in relation to securities lending) and the 1993 Act (in relation to repurchase transactions).

Each regime is subject to its own set of conditions:

(a) Derivatives : Article 52 of the 1996 Act

Article 52 of the 1996 Act allows termination and close-out netting in an insolvency situation, despite the provisions of Articles 37 and 56 of the French insolvency statutes. Three conditions are listed in Article 52 which relate to:-

- (i) **the nature of the Transactions existing between the parties:** Article 52 of the 1996 Act only applies to transactions relating to “financial instruments”, a broadly-defined notion which would nevertheless exclude spot transactions relating to assets other than securities (for example, spot FX transactions).
- (ii) **the documentation governing these Transactions:** Article 52 of the 1996 Act applies only to transactions governed by a master agreement "complying with the general principles of a national or international market master agreement", an undefined notion which is generally interpreted to include all industry standard documentation but precludes the use of in-house documentation.
- (iii) **the status of the parties involved:** Article 52 of the 1996 Act applies to the extent that at least one of the parties to the master agreement is (i) an eligible party (investment firms, credit institutions licensed to provide investment services, insurance companies, investment funds and some other entities) or (ii) a non-resident institution of comparable status. Thus, Article 52 would not apply to a master agreement concluded between two unregulated entities (for example, SPVs, corporates).

(b) Securities Loans : article 33 of the 1987 Act

Article 33 of the 1987 Act validates termination and close-out netting mechanisms in relation to securities loans using terms very similar to those used by Article 52. Yet, the following important differences should be noted:–

- (i) **the nature of the Transactions existing between the parties:** These are exclusively securities loans under the 1987 Act, which is defined so that transactions involving securities producing income giving rise to a tax credit in France will be excluded.
- (ii) **the documentation governing these Transactions:** Article 33 of the 1987 Act applies only to close-out made in accordance with the provisions of a "market master agreement organising the relationships between two parties". There is no reference to a market place or to the geographical scope of the agreement.
- (iii) **the status of the parties involved:** There are no special conditions regarding the status of the parties.

(c) Repurchase Transactions : the 1993 Act

The 1993 Act validates termination and close-out netting mechanisms in relation to repurchase transactions using a similar technique, with the following differences:–

- (i) **the nature of the Transactions existing between the parties:** These are exclusively repurchase transactions as defined by the 1993 Act, which is also defined so that transactions involving securities producing income giving rise to a tax credit in France will be excluded.
- (ii) **the documentation governing these Transactions:** The 1993 Act only applies to agreements approved by the Governor of the *Banque de France* in its capacity as chairman of the *Commission Bancaire*. To date, only the AFTB Master Agreement and the PSA-ISMA Global Master Repurchase Agreement have been so approved.
- (iii) **the status of the parties involved:** There are no special conditions regarding the status of the parties.

(d) Expected reform

The inconsistency of the various netting regimes has been criticised and it is expected that, under proposed reforms which will probably be implemented in the course of 1999, Article 52 will now become the central provision of French law dealing with this issue in respect of all the products referred to above and that specific statutes will refer to Article 52.

Along the same trend, the expected reform should allow “cross master agreement netting” and the creation of cross-product collateral arrangements.

See also the netting opinions provided to ISDA by Gide Loyrette Nouel of March 1998 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 France in relation to a counterparty organised in France? 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 France 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.

(a) Voluntary Arrangements

The relevant French rules in respect of voluntary arrangements are set out in Act no. 84-148 dated 1st March, 1984 as amended. A voluntary arrangements aims at solving the financial difficulties of a party by agreement with its main creditors in order to avoid bankruptcy.

No provision of the 1984 Act would prohibit contractual set-off.

(b) Insolvency Proceedings

The relevant French rules in respect of insolvency proceedings are set out in the Insolvency Act.

One general principle of the Insolvency Act is the prohibition under Article 33 of any payment by the bankruptcy receiver in respect of debts arising before the date of the initial judgement.

Except with respect to the special regimes of the 1987, the 1993 and the 1996 Acts, being limited to close-out netting in relation to specific transactions governed by a relevant master agreement, any contractual rights of set-off would be stayed by Article 33. Article 33 allows set-off between interrelated claims (*dettes connexes*). However, interrelation would usually require the relevant claims to arise in the context of a single agreement.

- 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?**

As stated above, French law allows several regimes in relation to title transfer collateral arrangements which are not uniform (see above, Question 10) and each regime is subject to its own set of provisions.

The risk of netting being disrupted by an intervener exists to a certain extent under French law. For instance, attachment by a third party creditor could, subject to certain conditions, operate to transfer title to an underlying asset to the attaching creditor, thus undermining the effectiveness of subsequent netting or set-off rights.

This risk has been specifically addressed by the netting regime set out in Article 52 of the 1996 Act. Under this provision, any attachment is deemed to have occurred immediately after the exercise of close-out netting rights, thus preserving the integrity of the close-out netting mechanism.

However, this risk has not been addressed by the netting regimes of the 1987 Act (in relation to securities loans) or the 1993 Act (in relation to repurchase transactions).

As discussed below (see 10 (d)) reform is expected which would unify the different netting regimes using Article 52 of the 1996 Act as the central provision of French law dealing with close-out netting.

- 13. In relation to mark-to-market collateral arrangements, is there any risk under the preference (or similar) rules of France 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, at least to the extent that any additional deliveries of collateral would be triggered by credit-related criteria (for example, variable thresholds based on the rating of the counterparty) as opposed to changes in the value of the underlying transactions. The risk would be even greater in respect of collateral arrangements based on a security interest approach which do not benefit from one of the above netting and collateral statutes.

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

The French Parliament has been very active over recent years to enhance the effectiveness and legal certainty of industry-standard netting and collateral documentation. As a result of the successive scattered statutes affecting various activities, French legislation now lacks consistency in this respect. The reforms referred to in Question 10(d) above should address these issues shortly. Also, the various statutes have promoted the transfer of title approach at the expenses of more traditional techniques based on a security interest which do not benefit from the same safeguards in a French bankruptcy. Given the complexity of the

characterisation issues involved in these matters (for example, how would a French court treat the security interest under an ISDA New York Credit Support Annex allowing for rehypothecation?), it is probable that the expected reform will also extend to collateral arrangements using a security interest approach.

The following points are also particular concerns:

- “Top-up” deliveries of collateral under mark-to-market arrangements are vulnerable to avoidance under preference rules.
- The enforceability of netting and/or set-off under a title transfer arrangement is potentially vulnerable to the rights of third party interveners such as attaching creditors and assignees.

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