

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

GERMANY

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 Germany 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 Germany in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in Germany 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 Germany and is simply intended to encourage debate and discussion of the relevant issues.

KEY POINTS FOR CONSIDERATION FOR GERMANY

- (1) The owner of a share in a pool of Fungible Securities would have absolute title to the assets as a co-owner.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is where the relevant securities are physically held or register located.
- (3) Conflicts of law rules would apply the *lex loci* with respect to a holding or the transfer of Fungible Securities and to the creation and perfection of a security interest in Fungible Securities.
- (4) If security assets which are Fungible Securities are held in Germany 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) It is unclear whether a pledgee may use pledged assets as its own property.
- (7) Formal procedures apply to enforcement of a security interest.

- (8) Enforcement of a security interest over Fungible Securities may not be delayed and is [not] stayed on insolvency.
- (9) Title transfer arrangements will not be recharacterised but certain mandatory requirements may apply.
- (10) Close-out netting under an ISDA Master Agreement is enforceable.
- (11) Contractual set-off is enforceable on insolvency.
- (12) Top-up collateral will not be avoided as a preference.

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

The German Civil Code (the "BGB") deals only partly with the nature of a participant's interest in securities.

2. How would such an interest be characterised under the laws of Germany?

Under German law a "security" is an instrument which provides that the owner of the certificate is entitled to claim the documented rights (for example, membership rights or claims) on presentation of the certificate.

Usually all bearer securities are represented by one or more certificates (immobilised or certificated securities). An issue of securities can be represented by a bulk of certificates, delivered to the holder which assumes possession over the respective security. With possession of the certificates the holder assumes a single and undivided interest in the certificates as well as in the securities represented by it. As a matter of practice all securities of the same issue are normally represented by only one certificate (global certificate), which is deposited with a custodian bank or a clearing organisation. The custodian bank or clearing organisation holds the certificate in its possession on behalf of the owners of the securities who thereby assume possession indirectly. Pursuant to this constructive possession (that is, the custodian's intention to possess on behalf of the actual holders and only in compliance with their instructions) the holders have co-ownership of the security. Under German law, all securities have to be represented by certificates. The only exemption is securities issued by the governments of the Federal Republic of Germany and of each *Bundesland*. These issuers can issue dematerialised securities (so-called "*Wertrechte*") which are represented through entries in the register of the Government's Debt Administration. Due to legal fiction, dematerialised securities are treated as immobilised or certificated securities and are governed by the same rules.

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

A security is located at the place where the certificate which represents the security is located. Dematerialised securities are located at the place where the register is located, which in the case of German securities is where the Government's Debt Administration register is administered.

4. Under German 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 and formal validity of a transfer of title to Fungible Securities?**

Conflict of law rules are governed by the Introductory Law of the Civil Code (the "EGBGB") which is, however, full of gaps. At the moment, the EGBGB contains no provisions regarding international property law. A bill published by the government in 1998 is still not enacted. Therefore the conflict of law rules regarding property laws (including the transfer and pledge of movable assets and securities) are based on customary law, as developed by the German courts.

A transfer or pledge of bearer securities and securities payable to order are governed by the laws of the jurisdiction where the certificate is located (*lex rei sitae* or *lex situs*)¹. The *lex rei sitae* principle also applies to (a) the characterisation of an interest as a pledge or as full title-transfer including (b), the creation of the security interest (c), its formal perfection and (d) (as far as German conflict of law rules are concerned) its effectiveness and validity. Non-negotiable securities, which are transferred by assignment, are governed by the law applicable to the documented claim.

It is a matter of discussion in legal literature whether the *lex situs* approach is appropriate for bearer securities which are deposited at a bank or a security organisation and where a transfer or pledge is documented only by booking of accounts. There is a strong body of opinion that the transfer of securities held through an intermediary should be governed by the laws of the jurisdiction where the intermediary (or the relevant account or register) is located. The Ministry of Justice has published a bill to amend the German Securities Deposit Act. A new § 17a would provide for significant extension of the *lex situs* approach. Dispositions (which includes transfers and pledges) of securities deposited in a collective safekeeping (Sammelverwahrung) or registered or booked to an account will be governed by the law applicable to the collective safekeeping arrangements or the register or the account as appropriate.

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

- (a) **cash?**

If cash means money held on deposit in a bank account (that is not coins and banknotes), a pledge is possible. However, the General Business Conditions (No. 14), recommended by the German Banking Association, provide that the customer and bank agree that the bank acquires a pledge on all claims which the customer has against the bank arising from the banking relationship (including any deposit account). If the General Business Conditions apply, all claims arising from the deposit account will be pledged automatically to the bank.

¹

Where a security payable to order is transferred by endorsement, the validity of the endorsement is governed by the law applicable to the documented claim.

(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.

Pledges of movable assets and rights are subject to separate provisions (§§ 1204 BGB), and these will apply to a pledge of any securities of the types mentioned above (§§ 1292, 1293 BGB). The main provisions are set out in § 1204 BGB pursuant to which a movable asset (such as a bearer security) may be used to secure any sort of claim and if necessary allows a creditor to apply the asset in satisfaction of its claim. The procedures for granting an effective pledge will depend on the type of asset. For bearer securities the owner must deliver the security certificates to the creditor together with a copy of the pledge agreement. If securities are deposited with a bank or clearing organisation the pledge may be effected by a transfer of (indirect) possession to the creditor by notifying the bank or clearing organisation of the pledge. Where securities are payable to order, they may be pledged by agreement between the creditor and debtor and by delivery of the endorsed certificate (§ 1292 BGB). Non-negotiable securities can be pledged by agreement and by notification of the security interest to the issuer of the securities (§§ 1279, 1280 BGB). As discussed below, these provisions also contain detailed rules regarding the enforcement of the pledge and the disposal of pledged assets. Some of these rules are mandatory and cannot be overruled by contrary agreement (§ 1245 BGB).

- 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.**

Cash in the form of a deposit can be pledged in the same ways as other claims. Agreement between the account holder and the creditor and the notification of the pledge to the relevant bank is all that is required. The agreement can be made orally. Normally, for purposes of evidence, however it is in writing. The pledge is perfected the moment the pledge is notified to the relevant bank (§ 1280 BGB). There are no further formal requirements.

A pledge of a bearer security requires an (oral or written) agreement between the owner of the security and the creditor granting the pledge and delivery of the relevant certificate. If the security is deposited with a custodian bank or clearing organisation (intermediary) delivery can be replaced by notifying the intermediary. There are no additional formal requirements. The same applies to securities payable to order which may be pledged by agreement and by delivery of the duly endorsed certificate. Non-negotiable securities are pledged like claims (see in relation to cash above).

- 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.**

Whether a pledge entitles the creditor to use the pledged assets is a matter of general legal controversy. § 1213 BGB provides that the rights of the pledgee can be constituted in such manner that the pledgee is entitled to receive the emoluments (the fruits and advantages) relating to the pledged assets. Nevertheless, emoluments are not the asset itself. There is a strong majority of the opinion that silence on the part of the legislature should not be

interpreted as a prohibition and that it is possible for the parties to agree that the pledgee is only obliged to release and re-deliver assets of the same number, type and quality (an irregular pledge). With respect to cash in the form of banknotes and coins pledged to a creditor this opinion has been confirmed by decisions of the superior courts².

- 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.**

Enforcement of a pledge is permitted only after notice has been given to the pledgor. The sale of the pledged assets may not take place until one month after the notice has expired (§ 1234 BGB). This period can be shortened by agreement (§ 1245 BGB). If the pledged assets are listed on a stock exchange or have a market price, the pledgee may effect a sale privately at the current price through a broker officially authorised to carry out such sales (§ 1221, 1235 BGB). Forfeiture provisions which provide that the ownership of the pledged assets may be appropriated by the pledgee are void (§ 1229 BGB). If it is not possible to sell the pledged assets on a stock exchange or for a market price the sale of the pledged assets is to be effected by public auction.

- 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 Germany 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.**

There is no risk of recharacterisation of a title transfer arrangement as a pledge. There is only the possibility that a court may hold that some rules relating to pledges should be applicable to the title transfer arrangement, to provide the debtor with a similar level of protection and to avoid the bypassing of mandatory rules (for example as discussed at the end of the answer to No. 8).

Transfer of ownership arrangements have not been the subject of legislation. Nevertheless, commercial parties and their legal advisors have developed different types of title transfer arrangement over the years, which have been enforced by the German superior courts (for example, the Federal Supreme Court, BGH) and which can therefore be considered as valid and enforceable instruments under German law.

An agreement which effects a title transfer arrangement is usually divided in two parts. First, the transfer of ownership of the security grants the creditor the legal powers of an owner of the underlying assets. The transfer of ownership is governed by the statutory provisions mentioned below (§§ 929 BGB, § 398 BGB). Pursuant § 903 BGB the owner is entitled to deal with the assets as he pleases and others, including the debtor, are excluded from any interference. Second to limit this extensive legal power the transfer is accompanied by an additional agreement whereby the creditor covenants to use the transferred assets only for the agreed purposes (a form of security).

²

See Bassenge in Palandt, BGB, Introduction to § 1204 BGB, No. 7.

The contents of the second agreement may be determined by the parties as a result of general principles of freedom of contract. Due to such principles a title transfer arrangement, that is, the second agreement, may provide that the creditor is entitled to use (sell, lend or re-pledge) the securities given to him as collateral and that he is obliged to release and re-transfer only securities of the same number and kind.

In some cases this has been restricted by the German courts in so far as certain mandatory rules would otherwise have been applicable if the parties had chosen to use a pledge (instead of a title transfer arrangement). These cases should not be regarded as recharacterisation of a title transfer arrangement as a pledge. They are merely an attempt to provide the debtor with a similar level of protection and to avoid the parties circumventing mandatory rules.

Title transfer arrangements relating to bearer securities or securities payable to order require agreement between the owner of the securities and the creditor to transfer ownership and delivery of the certificates (§ 929 BGB). If the bearer securities are deposited with an intermediary delivery of the certificates may be replaced by the transfer of the owner's claim against the intermediary for delivery of the certificates (§ 931 BGB). Notification to the intermediary is not necessary. However, to minimise the risk that the intermediary delivers the certificates to the debtor, notification is advisable. In practice, the transfer is effected by the owner giving instructions to the intermediary to transfer a specified amount of securities from his account to the account of the creditor. As discussed above, the transfer agreement is accompanied by a second agreement which is usually part of the same document. There are no further requirements.

The enforcement of title transfer arrangements is not governed by legislation, merely by the parties agreeing to enforcement procedures in the relevant agreement. Nevertheless the German courts have held that some mandatory provisions relating to pledges cannot be overruled by contrary agreement and will be applicable. One example is § 1235 BGB whereby an auction is required if a pledged asset has no stock exchange or a market price.

There are further requirements imposed by the General Business Conditions Act (AGBG) which provides that general business conditions should not deviate in a material sense from statutory requirements (§ 9 AGBG). There is therefore some debate whether it is permitted to deviate from § 1234 BGB which requires that a pledgor has to be warned within reasonable time before a sale of the pledged assets is allowed.

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?

Whether an agreement creates a pledge or amounts to a title transfer arrangement depends on its contents, which, if the wording is not clear, may be a matter of interpretation. Circumstantial evidence which may lead to the agreement being characterised as a pledge are the use of the term "pledge" and the fact that the debtor retains ownership of the assets. As mentioned above, there is no tendency to recharacterise a title transfer arrangements as a pledge.

10. Is close-out netting, for example, under a 1992 ISDA Master Agreement, enforceable under the laws of Germany? 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, for example, under a 1992 ISDA Agreement, is enforceable. This has been clarified by amendments to the German Insolvency Act in 1994. However there are some

remaining issues. For example, it is still unclear are whether spot foreign exchange transactions and commodity transactions are "financial forward transactions" within the meaning of the 1994 amendment. There is a strong body of opinion, reflected in the legal opinions given in respect of the ISDA Agreement and the German Master Agreement, that a close-out netting agreement covering those types of transactions is valid and enforceable under German insolvency law.

See the netting opinion provided to ISDA by Hengeler Mueller Weitzel & Wirtz of March 1998.

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

Two types of insolvency procedure exist, bankruptcy and judicial composition; both are set out in the new Insolvency Act ("IO"), which came into force on 1 January 1999. The bankruptcy procedure leads to dissolution of the relevant corporation. Judicial composition is used for financial reorganisations, and normally results in a reduction of the amounts owed.

Provisions of the IO, applicable to both proceedings, prohibit set-off only if (a) the creditor assumed the obligation towards the debtor after the commencement of the relevant insolvency proceedings or (b) the creditor acquired the claim against the debtor after the commencement of insolvency proceedings (§ 96 IO). Obligations agreed prior to the commencement of insolvency proceedings can be set off without any restrictions.

- 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?**

The issues relating to the ability of any third party claimants to disrupt set-off and netting are complex and not easily discussed in a summary of this type.

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

§§ 129 ff IO entitles a receiver to contest any legal act, transaction or disposition of the bankrupt prior to the commencement of the insolvency proceedings. This includes any transaction which grants the creditor a form of security for or repayment of an existing debt (a) within the three months immediately prior to the bankruptcy petition being presented (if the creditor had knowledge about the levels of indebtedness of the bankrupt at the time of the transaction (§ 130 IO)) or (b) within the month immediately prior to the bankruptcy petition

being presented (if the creditor received security or repayment of an obligation to which he would not otherwise have been entitled (§ 131 IO)). A delivery of securities resulting from the revaluation of an exposure would not be contestable under § 131 IO if it is effected merely to comply with the provisions of the collateral agreement because the creditor would have an existing claim to the assets transferred. The position under § 130 IO in relation to transfers within the 3-month-period is more difficult. However, the burden of proof regarding the knowledge of the creditor lies with the receiver.

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

Please note that the ownership of bearer securities³ (negotiable or fungible securities) passes on the transfer of title to the certificates which represent the security. The transfer itself is governed by the same rules which are applicable to the transfer of interests in movable things (§§ 929 BGB). Securities to order can be acquired by the physical transfer of the certificate combined with an endorsement. The owner of the certificate is entitled to claim the documented rights solely if he is able to present a certificate with an unbroken and complete chain of endorsements on its back. On the other hand, blank endorsed securities to order are treated as bearer securities. Non-negotiable securities are issued to a specified person who is named in the certificate. Non-negotiable securities must be transferred by assignment of the documented claims (§ 398 BGB). Transfer of ownership of the certificate is not a condition for the security's transfer. On the contrary, if the documented rights have been assigned to the new holder, he automatically acquires ownership of the certificate by law (§ 952 BGB).

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³

For example, all shares, except registered shares which are securities payable to order (§ 68 Company Law), all bearer bonds, bearer cheques, and promissory notes made out to bearer.