THE RIGHT OF COLLATERAL TAKER TO USE COLLATERAL

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This article follows up on the author's article published in BIATEC 12/2005, in which he discussed the conditions for using collateral by secured creditors.[2] However, in order to implement this particular legal institute in practice, to examine the conditions for its application is not enough; one also has to look into the legal aspects of the actual use of such collateral and the subsequent settlement between the collateral provider and taker.

Use of collateral

Legal provisions regulating the use of collateral by secured creditors can be found in the Securities Act and the Civil Code, as amended by the 23 June 2005 Amendment.[3] At the European level, this issue is addressed by the Financial Collateral Directive.

The method and the extent of collateral use

The method. Subject to conditions laid down by law, the 23 June 2005 Amendment entitles the pledgee to "handle" collateral, which is a term similar to that used in the German translation of the Financial Collateral Directive. The English version and the French translation of the directive use the term "to use and dispose of" collateral.[4] Without going into a deeper analysis of these terms used in the directive, it is obvious that the meaning is supposed to cover the use of collateral, including its sale, as well as a further pledge of collateral or, where appropriate, any other agreed "use".[5]

The use of collateral must be consistent with the pledge agreement regarding the asset in question. It is recommended that the agreement explicitly set out the method of collateral use. Under applicable law, the pledgee disposes of collateral on behalf of the collateral provider and for its own account, since the collateral taker is not the owner.[6]

The sanction of invalidity of disposal of collateral at variance with the agreement needs to be examined individually for securities and receivables on account. Although in both cases, the asset concerned is disposed of by an unauthorised non-owner, the assignees of the asset enjoy different kinds of protection. For the buyer becomes the owner of the security, even if the seller had no right to transfer it, unless at the time of the transaction the buyer knew or must have known that the seller was not entitled to sell the security.[7] If the security is pledged, the above rule no longer applies to the use of the collateral by pledge,[8] nor does it if a receivable on account is used by assignment or pledge.[9] In that case, unauthorised use results in the invalidity of the legal action concerned.

The extent. The parties should not overlook the fact that collateral value may, from the very beginning or at some point during the life of pledge, exceed the value of the claim secured. Subject to conditions laid down by law, the Slovak collateral legislation does not restrict the collateral taker's right to use collateral in its entire value, even if it were several-fold the value of the secured claim. In case the debtor wants to deny his creditor this economic benefit, this right should be restricted accordingly upfront in the agreement on use of collateral.

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[1] The author is a legal counsel to the European Investment Bank. The opinions expressed in this article are those of the author and might not necessarily be identical with the views held by the European Investment Bank.

[2] Baláž, P.: Conditions for the use of collateral by a secured creditor. Biatec 12/2005, p. 16-21. NBS Bratislava. The terms and abbreviated titles of regulations defined in the previous article and used here have the same meanings.

[3] National Council of the Slovak Republic Act No 336/2005 Coll. amending Act No 566/2001 Coll. on securities and investment services and amendments to other laws (Securities Act) as amended (referred to as "Amendment" or "Amendment to the Securities Act" in the text).

[4] "use and dispose" in the English, "utiliser et aliéner" in the French, and "verfügen" in the German version.

[5] See, for example, the purpose of the right to use collateral in the explanation to Article 19 of the directive.

[6] Securities Act, Article 53b(1), and Civil Code, Article 151me(5).

[7] Securities Act, Article 19(3).

[8] Securities Act, Article 51(2). This principle has to be distinguished from cases where the securities are transferred pledge-free to a third party (see, for example, Article 53a(4)).

[9] Civil Code, Articles 524(1) and 151d(3).

Termination of pledge over used collateral

Time specification. The moment when used collateral is freed from the pledge right is critical. The Amendment states clearly that the pledge has no effect on the acquiror of the originally pledged collateral upon its disposal by the collateral taker (creditor).[10] This is a perfectly pragmatic requirement. For was the pledge to exist from the moment of collateral use until its substitution by equivalent collateral, the use of collateral would be rendered virtually useless. The continuation of the pledge on the original collateral during the period of its use would, among other things, complicate or even prevent its further pledging.[11]

In this respect, it is common to refer to the obligation imposed on member states by the Financial Collateral Directive to ensure that securing a creditor by equivalent collateral be not ruled invalid just because the original collateral was used.[12] Some authors relate this particular provision to the prohibition of invalidating a pledge over equivalent collateral on the ground that the use of the original collateral resulted in the cessation of the pledge and that there is no mechanism for its renewal in respect of the equivalent collateral.[13]

This particular article of the directive is going to play a critical role in preventing courts from declining transfers of pledge over equivalent collateral on the argument that such a pledge expired, for instance, as a result of an agreement that the collateral provider may transfer the collateral pledge-free (since in case of use the collateral taker acts on behalf of the collateral provider)[14] or because the assignee of the security was unaware of the pledge or acquired the security in an anonymous transaction.[15]

Multiple pledges. Cases where a has an account receivable is pledged to several pledgees with different ranking call for special attention.[16] The collateral taker may transfer such a claim to a third party in return for appropriate consideration which, however, is bound to fall short of its face value. In such case, the pledges held by other creditors generally do not expire, but pass on with receivable on account. As a result of the transfer, not subject to the consent of other collateral takers (creditors), the collateral acquirer becomes the pledgor, a fact that may not be acceptable to other collateral takers. In this context, there are doubts as to how courts would handle the conflict between the subdebtor being prohibited from paying his due liability to a third party without the consent of other collateral takers[17] and the right of any of the collateral takers to use the collateral by means of a claim assignment.

Another situation to point out here is where the collateral taker is granted the right to use a receivable on account by its payment to an account with another bank. The funds thus remitted are no longer subject to any pledge, since this event generally does not constitute a claim assignment. Again, the law does not require the consent of other collateral takers, not even higher-ranking ones. As a result, in case of an agreement allowing the collateral taker to transfer back equivalent collateral to a different account, they may end up with no material collateral left.

To prevent this, the possible advice is to forbid the pledgor contractually to pledge the same receivable on account in favour of third parties, or at least to oblige the debtor contractually not to grant such parties the right to use collateral.

Title transfer collateral and repo transactions

As far as title transfer collateral goes, there is no certainty inside the Slovak legal community as to whether a secured creditor may use the collateral.[18] Given the nature of the ownership right and the fact that such use is allowed to qualified pledgees, there is no reason to deny such disposal to a creditor secured by title transfer collateral. And in repo transactions this problem should be out of the way completely.

When using title transfer collateral or securities delivered in a repo transaction, the collateral taker disposes of the asset concerned in its own name and for its own account.

Settlement after collateral use

If a secured creditor exercises his right to use collateral before the due date of the claim secured, it is necessary that he settle with the debtor on the due date of the claim at the latest. In this article, we will look at three methods of settlement: (i) return of equivalent collateral; (ii) set-off of mutual claims or, where appropriate, close-out

[10] See Securities Act, Article 53b(2) and Civil Code, Article 151me(5).

[11] Multiple contractual pledge is not allowed in case of securities (Article 48(3) of the Securities Act).

[12] Financial Collateral Directive, Article 5(4).

[13] Morton, G.: The Collateral Directive. In: Raffan, M.: A Practitioner's Guide to EU Financial Services Directives. City&Financial Publishing, London, First Edition, p. 183.

[14] Article 151h(1) of the Civil Code.

[15] Article 53a(4) of the Securities Act.

[16] In principle, this is impossible with securities (Securities Act, Article 48(3)).

[17] Civil Code, Article 151mb(3).

[18] For details, see Baláž, P.: Conditions for the use of collateral by a secured creditor. Biatec 12/2005, p. 16-21. NBS Bratislava.

netting; and (iii) use of equivalent collateral for settlement.

Return of equivalent collateral

Pledge. After using collateral, a collateral taker may settle with the collateral provider, before or on the due date of the claim secured, by furnishing equivalent collateral on behalf of the collateral provider. Such collateral must be provided on the due date of the claim secured at the latest.[19]

Statutory equivalent collateral. Equivalent collateral in case of a pledge over securities means a fungible security.[20] In case of receivable on account, equivalent collateral is a receivable on account or a different form of deposit with the same amount and currency vis-à-vis the same debtor. Interestingly, under the current law this need not be a receivable on the same account, or even the same form of deposit, or having the same maturity as the original collateral. Unlike the Financial Collateral Directive, the Amendment requires the receivable on account to be vis-à-vis the same debtor.

The fact that, as regards receivables on accounts, the directive stops short of specifying any details on equivalent collateral indicates that the provision of cash collateral, i.e. in respect of receivables on account, takes the shape of a transfer of the relevant amount in the given currency from one account to another, rather than an assignment of receivables on account.

Contractual equivalent collateral. Playing the role of equivalent collateral may also be a different asset, if the collateral taker and provider so agree.[21] The Slovak law grants the parties an even greater contractual freedom than the Financial Collateral Directive, which only does so in respect of financial instruments.[22] This approach is certainly welcome.

Substitution of original collateral. Equivalent collateral replacing the original one is subject to the same pledge. The law sets out no special requirements for the substitution of original collateral. The Amendment implies that this happens through the provision of equivalent collateral on behalf of the collateral provider and for the account of the collateral taker. However, it is in the interest of both parties that the provision of equivalent collateral be beyond any doubt. That is why it is advisable to notify the collateral provider in a provable manner.

The question is whether such substitution is analogically subject to the provisions on the establishment of pledge under the special implementation regime of the Financial Collateral Directive, in particular as regards securities.[23] According to the Securities Act, it is sufficient to "provide, on behalf of the collateral provider and for own account, equivalent collateral to substitute the original collateral". The Amendment says nothing about collateral endorsement, delivery or registration in the relevant owner account or other relevant registry. Although the law does authorise the collateral taker to "order the registration of a transfer on behalf of the collateral provider also in case of the delivery of equivalent collateral", this provision needs to be interpreted as relating to the acquisition of an ownership right to equivalent collateral by the collateral provider, rather then to pledge registration. Thus, it is more likely that the pledge is transferred to equivalent collateral ex lege upon its provision. The method of recording such pledge, however, has yet to be stipulated by law.

Ranking. The ranking of the pledge on equivalent collateral is determined by the rank of the pledge over the original collateral. This fact is critical, as in other aspects it had been generally possible for the collateral taker even before, if agreed and on basis of appropriate powers of attorney, to use the collateral and to terminate the original pledge. Nevertheless, when returning equivalent collateral, it was necessary to establish and register a new pledge with a new ranking.

Multiple pledges. Let us go back to the example of multiple pledges over a receivable on account used by assignment. If, following the use of a receivable on account subject to several pledges, the collateral taker returns an equivalent receivable on account with the same amount and currency and on the same debtor, the original pledge over receivable on account does renew, but only the pledge of the pledgee concerned. Other pledges, subject to fulfilment of conditions laid down by law, remain attached to the original collateral.[24] In this case, equivalent collateral is not really

[19] Financial Collateral Directive, Article 5(2), Securities Act, Article 53b(2), and Civil Code, Article 151me(6).

[20] Fungible securities are securities of the same type and form issued by the same issuer, provided that carry identical rights (Article 7(2) of the Securities Act).

[21] Securities Act, Article 53b(3), Civil Code, Article 151me(6).

[22] Financial Collateral Directive, Article 2(1)(i).

[23] Securities Act, Article 53a(2) and (3).

[24] If a returned equivalent receivable is mixed with an unused pledged receivable on account, or depending on the definition of the subject matter of the pledge agreement, under some circumstances other pledges may renew as well. Their ranking, however, needs to be studied separately.

completely equivalent, since it may not be subject to the other pledges. Therefore, under the current law, the collateral taker will probably not be interested in assigning a receivable on account which is subject to multiple pledges, because it would most likely yield less than what he would have to return in form of equivalent collateral.

These conclusions do not apply to the use of a pledged receivable on account by transfer to an account with another bank, where other pledges remain attached to the original receivable on account.[25] Depending on the nature of pledge agreements, the return of funds to an account enhances material collateral for other collateral takers. Apart from that, the pledge held by the collateral taker concerned is renewed to the extent of equivalent collateral returned. These conclusions are not laid down directly by law and may, unfortunately, only be inferred from the nature of the institute of collateral use by a collateral taker and from the legal term "to provide equivalent collateral". The introduction of legal certainty into this particular issue would be certainly welcome.

Equivalent collateral. Even if a collateral taker uses collateral for a purpose other than sale, he is still obliged to return equivalent collateral. In other words, if he pledges the original collateral in favour of a third party, he must return equivalent collateral, not the original one. In this context, however, we need to determine the owner of the original collateral, if the collateral taker provides the collateral provider with equivalent collateral. Otherwise, the original collateral would remain the property of the collateral provider. In such case, in respect of receivables on account, the Amendment explicitly states that the collateral taker becomes the owner of the original collateral by law.

Unfortunately, there is no similar provision in respect of securities. This shortcoming is probably the result of the rule that "pledged securities must not be the subject of a security pledge agreement".[26] However, this wording probably runs counter to the European law. For if a collateral taker wants to use a pledged security to pledge it on, he generally needs to enter into a security pledge agreement before the disposal by pledge occurs and the original pledge expires.[27]

[25] The author follows the legal qualification of a bank transfer as described in Baláž, P.: Condition for the use of collateral by a secured creditor. Biatec 12/2005, p. 16-21. NBS Bratislava.
[26] Securities Act, Article 18(3).
[27] There would probably be no contradiction if the rule did not apply to the conclusion of a pledge agreement in respect of a pledged security, but rather prevent the rise of another contractual pledge on an already pledged security.

The future will show whether Slovak courts will chose the interpretation that the special legal provisions concerning the right to use collateral overrides this general ban. Not even such interpretation, however, will resolve the question of the ownership title to the original collateral.

Title transfer collateral. Equivalent collateral replacing collateral received through a title transfer is also to be returned to the collateral provider on the due date of the obligation secured, assuming the collateral provider settled the obligation and the parties have not agreed otherwise.

This argument is inferred from the Financial Collateral Directive.[28] Furthermore, the directive implies that the use of collateral should also be possible in title transfer collateral. The problem with the Slovak law, however, is that title transfers act as a hybrid of pledge and an outright title transfer. In bankruptcy proceedings, same from 1 January 2006 onward, they will still be treated similarly as pledge. Title transfer collateral will fall into (a separate) bankruptcy estate despite the fact that it is not the bankrupt's property.[29]

If a secured creditor disposes of collateral, the application of the Slovak bankruptcy law is unclear. Title transfer collateral is not based on the institute of security interest, but on a transfer of title instead. That is why the relevant provisions of the directive concerning the renewal of security interest will not apply here. It seems that the hybrid nature of title transfer collateral under the Slovak law is incompatible with the Financial Collateral Directive. It is because member states are obliged to ensure that a full right of ownership is acquired in title transfer collateral[30], which is apparently not the case in bankruptcy proceedings if the property of a secured creditor is not off limits to debt claims on the collateral providing debtor. The market can effectively bypass this fault by concluding recognized close-out netting agreements, but that does not mean the Slovak law is in line with European legislation in this respect.

Repo transactions. In repos, the situation regarding the return of equivalent assets is clear. In a reverse repo, a contractually agreed asset is transferred, as well as fungible securities or an appropriate amount in a given currency.

[28] Financial Collateral Directive, Article 6(2).
[29] Bankruptcy and Restructuring Act, Article 67(1)(c) and Article 69(a).
[30] Financial Collateral Directive, Article 6(1).

Set-off

Set-off on the planned due date of the claim. According to the directive, a collateral taker may, as an alternative to transferring back equivalent collateral, set off the value of his obligation to return equivalent collateral against the relevant claim, if and to the extent the terms of the collateral agreement so provides.[31]

The collateral taker has this right on the due date of the claim secured. The Amendment positively allows such set-off even later, i.e. not only on the due date. For it may happen that both parties would be in delay without taking action towards an offset on the due date. On the other hand, were the Amendment to be interpreted literally, these mutual claims could also be set off prior to the maturity of the claim secured.[32] It is desirable to rule out this possibility contractually, rather than rely on the present wording of law.[33]

Netting before the planned due date of the claim. According to the Financial Collateral Directive it is possible to proceed with a netting, in economic terms,[34] on the basis of a close-out netting agreement, not only for pledge collateral, but also for collateral to be returned under title transfer collateral arrangements.[35] The close-out netting agreement typically allows automatically, or at either party's request, that designated mutual claims be replaced by a single payment obligation on occurrence of a certain event.[36] The directive calls this an "enforcement event", i.e. a default on a contractual obligation or any similar event as agreed between the parties.[37] In financial market practice, similar events means bankruptcy or winding-up proceedings, or corporate, tax or other adverse changes, as well as cross default.[38]

[31] Financial Collateral Directive, Article 5(2) second sentence. From the Slovak law perspective, this means an offset of claims corresponding with these obligations.

[32] Securities Act, Article 53b(2) and Civil Code, Article 151me(7).

[33] The possibility to rule out contractually unilateral set-offs is based primarily on the legal doctrine and the dispositive nature of applicable regulations. Slovak authors usually leave this issue untouched, but continental legal theorists speak clearly in favour of contractual autonomy in set-off prohibition (see, for instance, Rummel, P. and others: Kommentar zum Allgemeinen bürgerlichen Gesetzbuch. 2. Bank. Manzsche Verlags- und Universitätsbuchhandlung: Wien 1992, p. 1166).

[34] For term definition see Baláž, P.: Offsets in financial markets: Part 1. Offsets in General. Biatec 1/2005, p. 23-26. NBS Bratislava.

[35] Financial Collateral Directive, Article 6(2).

[36] Financial Collateral Directive, Article 5(5), Bankruptcy and Restructuring Act, Article 180.

[37] Financial Collateral Directive, Article 2(1)(l).

[38] See, for example, the definition of Event of Default and Termination Event (Part 5) in the 2002 ISDA Master Agreement, with the Credit Support Annex or Credit Support Deed forming an inseparable part, or Event of Default (Article 10) in the ISMA (now ICMA) Global Master Repurchase Agreement.

Set-off in bankruptcy. Set-offs have been practically impossible after the commencement of bankruptcy or certain other reorganisations measures. However, the new Bankruptcy and Reorganisation Act now basically allows set-off and netting and, in addition, introduces close-out netting. According to the Act, close-out netting may also be applied in "transactions in collateral rights", which is probably a rather inaccurate translation of the term collateralisation normally used in this context. Neither a pledge nor a title transfer are formally a transaction in collateral rights, because they do not involve the purchase or sale of collateral rights. It is therefore necessary that the lawmakers find a more accurate term.

The second problem with the law is that the possibility of close-out netting in respect of collateralisation only covers the rights over financial instruments. There is no definition of the term financial instrument in the Bankruptcy and Reorganisation Act, but there is one in the Securities Act.[39] Although the term covers other instruments in addition to securities, it does not cover receivables on accounts.

If collateral were provided to secure claims resulting from other transactions specified in the Bankruptcy and Reorganisation Act, objections to the application of a special regime to such close-out netting (despite the problems mentioned above) could by declined on the basis that such collateral was related to such other transactions and affects the estimate of profits and losses arising in connection with the closing-out or cancellation of such other transactions.

Against this background, repos once again seem to be safer tool, because they are clearly covered in the close-out netting legislation under the terms "transactions involving a transfer and reverse transfer of securities" in respect of securities and "transactions in foreign exchange assets" in respect of currency repos.

Set-off in receivership. Close-out netting between qualified institutions also needs to be studied against regulations other than the Bankruptcy and Reorganisation Act. If certain institutions are placed under receivership, which the Bankruptcy and Reorganisation Act considers special restructuring proceedings, creditors are generally unable to set off their claims against such institutions for a certain period of time.[40]

By way of exemption from the offset ban in receivership, in certain cases the lawmakers attempted to implement the possibility of set-off and netting in broa-

[39] Securities Act, Article 8(m).

[40] See, for example, Article 59(2) of the Banking Act, Article 153 of the Securities Act, or Article 57(1) of the Insurance Act.

der economic terms in accordance with special directives devoted to insolvency in such institutions.[41]

However, these lines of implementation are not quite satisfactory from the perspective of the Financial Collateral Directive, as: (i) all of them explicitly rule out the possibility of close-out netting in respect of all relevant collateral after the commencement of receivership; and (ii) even if they do allow such close-out netting or set-off in extraordinary cases, such cases do not cover the entire scope of application of the Financial Collateral Directive. Unfortunately, as long as the inconsistency with the European law remains in this particular area, the financial market will find the use of collateral unfit in many cases. For instead of close-out netting, a more complicated procedure would have to be followed: first return equivalent collateral to the collateral provider/debtor placed under receivership and only then exercise the pledge on collateral, if possible at all.

Use of equivalent collateral for settlement

Pledge. Where a collateral provider and collateral taker have so agreed, equivalent collateral may also be used to settle the claim secured. In the light of the Financial Collateral Directive, this means the collateral taker is able to satisfy his secured claim by an obligation to provide equivalent collateral. This method of settlement between the collateral taker and provider after the use of collateral can be considered if the collateral provider is not the debtor. For in such case it is not possible to set off the secured claim against a claim corresponding to the collateral taker's obligation to return equivalent collateral, since these are not mutual claims.

Although it is good to see that this method of settlement did not go unnoticed in the implementation of the Financial Collateral Directive, the current wording "to use equivalent collateral for settlement" is not the most fortunate, as it suggests the need to acquire ownership of equivalent collateral to be able to use it for settlement. Such use of collateral for settlement can be interpreted in several ways, e.g. as a possibility to cash equivalent collateral and then pay its value to the collateral provider. However, the term is rather supposed to mean that, instead of providing equivalent collateral, the collateral taker should be able – by manifestation of will – to cause the obligation to provide equivalent collateral and the debtor's obligation to perform the secured claim to be discharged to the extent in which their financial values match.

Title transfers and repo transactions. Since the Slovak legislation does not provide for this type of settlement in title transfers, we may refer to the general principles. Repo transactions do not require similar legal provisions, since here it is always the financed party who transfers an asset to the financing party in return for a purchasing price used as funding for a certain period.

Conclusion

Following the previous, less refined implementation of the Financial Collateral Directive, this time the lawmakers have taken a cautious approach to the use of collateral by secured creditors in the latest Amendment to the Securities Act. The impulse to strengthen the Slovak financial market through the right to use collateral is perfectly welcome. However, given the number of problems in legal application of the use of collateral by the collateral taker which still remain outstanding, it should not be overestimated.

What seems even more problematic is the situation in title transfer collateral. Due to the current legal problems associated with this particular institute, it can be considered as good as dead, and not only from the perspective of use of collateral by secured creditors. In order to revive this institute it will be necessary, among other things, to ensure the untouchability of collateral in bankruptcy proceedings imposed on the collateral provider and explicitly stipulate the right of its use or exercise. The debtor and the creditor may still take advantage of the legally more straightforward and safer repo transaction.

Efforts to provide for a pledge carrying a right to use collateral in a manner satisfying financial market needs should not be given up. For this right becomes particularly interesting where the debtor does not want to lose control of collateral completely. It gives the debtor a new opportunity to optimise the trade-off between the cost of financing and the protection of his interests. That is why it will be more than welcome for the lawmakers to start a new initiative in the near future to develop the legal implementation of this institute to a level living up to the criteria of legal certainty and practical application.

[41] For example, the European Parliament and Council Directive 2001/24/EC on reorganisation and winding-up of credit institutions or the European Parliament and Council Directive 2001/17/EC of 19 March 2001 on reorganisation and winding-up of insurance institutions.