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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 137 - EUROPEAN COMMISSION REVIEW OF ARTICLE 14: ASSIGNMENT

Response to the November 2009 Ministry of Justice Discussion Paper on the effectiveness of an assignment or subrogation of a claim against third parties

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 137 WORKING GROUP

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1 Introduction

1.1 In November 2009, the Ministry of Justice published a Discussion Paper entitled "European Commission Review of Article 14: Assignment" (the "Discussion Paper"). The Discussion Paper is concerned with the legal position of third parties in cases where a contractual claim has been assigned to another party and, in particular, the effectiveness of an assignment against third parties and the priority of the assigned claim over the rights of third parties. These issues are examined in the context of a report which the European Commission is expected to submit to the European Parliament, the Council and the European Economic and Social Committee by June 2010 on assignment and subrogation (this report is likely to be accompanied by a proposal to amend the Rome I Regulation).

1.2 The role of the Financial Markets Law Committee (the "FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed. This paper, therefore, does not consider policy issues raised in the Discussion Paper that are relevant to assignment of claims other than as necessary to deal with matters of potential uncertainty or misunderstanding.

1.3 The FMLC, in two papers dated April and October 2006, commented extensively on a provision contained in the European Commission's 2006 Proposal for a Rome I Regulation (the "Commission's Proposal") which sets out a rule of the kind considered in the Discussion Paper and referred so-called "priority issues" to the law of the assignor's residence. In its own papers the FMLC rejected this approach and strongly asserted that the law of the underlying claim is the ideal rule, in order to protect both the legitimate expectations of the debtor and the principle of party autonomy.

1.4 However, the FMLC understands that it is necessary to reach a compromise between the law of the underlying claim and the law of the assignor's residence and accepts that other Member States, who supported the Commission's Proposal, will not accept the exclusive application of the law of the underlying claim. Given these circumstances, the FMLC

considers that the Ministry of Justice's version probably reflects a necessary political compromise.

2 United Kingdom compromise

2.1 *Question 1: Is the general scheme of the proposed solution satisfactory?*

2.1.1 There are strong arguments that the law governing the contract to be assigned should govern not only its assignability but also whether the assignment is effective against third parties. This would appear to be consistent with the principle of party autonomy. In other words, there is a strong argument that the parties who between themselves have created a contractual right should determine the law that will govern these issues. The application of the law of the assignor's habitual residence would override this basic freedom. There are, however, a number of other arguments in favour of this rule. In what follows, the FMLC, adhering strictly to its remit, discusses the proposed rule from the perspective of participants in the financial markets.

2.1.2 First, the application of the law of the assignor's residence—the alternative proposed in the Commission's Proposal—could lead to legal uncertainty and inconsistencies. These problems arise as a result of the fact that the assignor may change his residence at will and are exacerbated if the relevant test is the assignor's habitual residence *at the time of assignment*. If the assignor assigns a debt or claim when resident in country A, perhaps by way of charge or other security interest, and then relocates to country B, having retained *de facto* possession of the debt, and then re-assigns it, the question of the priority of the assignees' respective interests could, arguably, be governed by the law of country B or the law of country A. If the first charge is effective and takes priority under the law of country A but the later assignment takes priority under the law of country B, then the priority question is legally susceptible to two entirely different and incompatible answers.

2.1.3 Secondly, the same rule would unfairly prejudice the interests of the underlying debtor precisely because of the uncertainties just identified. It is important for several reasons for the underlying debtor to be able to identify the person entitled to lay claim to the debt in priority to other assignees. This is all the more true if, as interpreted by national courts and the Court of Justice of the European Union, the rule is held to govern or affect any

aspect of the relationship between the debtor and the assignee, contrary to the understanding of the FMLC that such aspects will be characterized as "paragraph 2 issues" (as defined in the Discussion Paper). (The FMLC would be strongly opposed to such an interpretation or development.) Identifying the person entitled to lay claim to the debt, in turn, requires certainty on the debtor's part as to which law governs "paragraph 3 issues" (as defined in the Discussion Paper)—a certainty that a rule referring to the law of the assignor's residence cannot provide.

2.1.4 It is certainly true that (as the FMLC understands) paragraph 2 issues include the question as to who is entitled to sue the debtor (the relationship between the assignee and the debtor/the conditions under which the assignment can be invoked against the debtor), as well as who is able to give a good discharge. Thus, the debtor is primarily concerned with his position under the system of law to which paragraph 2 of Article 14 refers, i.e. the law governing the underlying debt. Nevertheless, the debtor may still need to know which party is entitled in priority to other assignees—a "paragraph 3 issue"—if the law which governs "paragraph 2 issues" itself refers to that entitlement as a condition under which the assignment can be invoked against the debtor or fails to provide that the original assignor can give a good discharge.

2.1.5 In response to this, it is sometimes argued, by those that support the rule set out in the Commission's Proposal, that a debtor does not need to know who owns the debt but merely whom he should pay and, if he mistakenly pays the original assignor rather than the assignee, that should not matter very much either because most legal systems will require the assignor to indemnify him against any claim by the assignee in those circumstances. This, however, does not quite tell the whole story. Not only may a financial markets debtor like to know who ultimately controls the enforcement of his obligation for reasons that have little to do with title to sue or the giving of a good receipt—one might call this the "vulture fund" objection—but it is also true that the extent to which an indemnity is available and enforceable is a question for the applicable law. The FMLC is not aware of any research on the point but it seems doubtful that the position of a debtor who has mistakenly paid someone other than the owner of the debt is, with regard to the availability of an indemnity, clear beyond any doubt under all the legal

systems of Europe, let alone the world. Even were it to be so there would still be doubt about the practicality of enforcing that indemnity swiftly and efficiently.

2.1.6 Thirdly, attributing relevance to the assignor's residence may add to the costs of some transactions. In most markets, an assignee of a debt must already consider issues arising under the applicable law of the contract of assignment and the *lex contractus*. This is considered to be no more than basic due diligence on the debt in virtually every context (although, see paragraph 2.1.9 below for comments on factoring and discounting) and, certainly, is a practice that should be expected and encouraged as a matter of market "hygiene". A rule favouring the law of the assignor's habitual residence in relation to priority questions, however, would force the assignee to investigate yet another system of law before he can properly assess his rights which would increase the time and costs involved in such a process.

2.1.7 The simplest and most elegant solution is to allow the law identified under Article 14(2) to apply also to those matters which are the subject of paragraph 3 *tout court*. This might be achieved as follows: "The law designated by paragraph (2) shall also govern the question whether the assignment or subrogation may be relied on against a third party, including a competing assignee of the same right". However, the FMLC accepts that political realities compel a compromise. Accordingly, we now turn to the draft Article 14 prepared by the Ministry of Justice (i.e. the UK compromise).

2.1.8 The UK compromise contains two exceptions to the *lex contractus*, invoking the application of the law of the assignor's residence: the factoring and the consumer exceptions.

2.1.9 The first exception concerns factoring. The FMLC understands that this industry, as a whole, supports a rule favouring the law of the assignor's habitual residence as the appropriate conflicts rule for priority questions. The reason for this preference relates to the costs point made in paragraph 2.1.6 above. Factors, it is understood, do not always undertake comprehensive due diligence on the individual debts which are assigned to them in bulk. Instead they may acquire the debts at a value which is generously discounted to reflect the overall statistical likelihood of a proportion of the debts

becoming subsequently unenforceable. Thus, the main concern of a factor or other distressed lender is not "Can I enforce the debt I have acquired against the underlying debtor?" but rather "How can I guarantee that the client has not granted a security interest over this portfolio of debts which takes priority to my assignment?" (This may be an especially pressing concern in situations where the client-assignor operates the book of debts as agent for the assignee-lender.) In these circumstances, there is an efficiency to be gained in a conflicts rule which refers priority questions for a mixed portfolio of debts to a single legal system (i.e. the law of the client-assignor's habitual residence). Therefore, the FMLC accepts that this exception is desirable from the perspective of the factoring industry and related industries.

2.1.10 Reasons for a consumer exception—beyond the obvious political imperative of reaching a compromise in this area with other Member States who have espoused the European Commission's original recommendations on priority—are less clear. Paragraph 3 simply refers to assignments by consumers. The reference to the consumer's habitual residence is not limited by factors such as those that restrict the application of Article 6 (Consumer contracts). This exception should, in any event, be kept as narrow as possible. The FMLC considers the current draft to be an acceptable compromise.

2.1.11 With regard to the definition of the habitual residence for companies, the current reference to Article 18 should be amended to refer to Article 19.

2.1.12 Paragraph 5 should include a reference to subrogation. The super-conflict rule contained in paragraph 5 should refer to paragraph 4 and not to paragraph 3 (the super-conflict rule should provide that the *lex contractus* prevails over the law of the assignor's residence—see page 14 of the Discussion Paper).

2.1.13 Appendix II contains two definitions of the concept of assignment (Articles 14.6 and 14.7, page 25 of the Discussion Paper). The FMLC suggests that the definition in Article 14.7 is adopted.

2.1.14 Finally, if the Ministry of Justice's proposal for paragraph 3 of Article 14, or any similar rule, is the necessary outcome of a political compromise, it must be made absolutely clear (by means of a recital or amendment to the text) that paragraph 3 shall not affect the

obligations of the debtor, including (in particular and without limitation) any question whether a payment by the debtor has discharged the debt and any question as to the identity of the person or persons entitled to take legal proceedings against the debtor to enforce the debt.

3 Judgment debts

3.1 ***Question 2: Should there be a rule that the assignment of judgment debts is governed by the law of the court that granted the judgment; and should this apply to paragraph-2 issues as well?***

3.1.1 The FMLC is aware that there are arguments to be made in favour of more than one approach in this regard. It does not, however, regard the assignment of judgment debts as a pressing market issue.

4 Intellectual property

4.1 ***Question 3: Should special provision be made for assignments of intellectual property? If so, should the applicable law be that under which the IP right arose or was created? Should this apply to paragraph-2 issues as well?***

4.1.1 The FMLC does not have a view on this question.

5 Shares

5.1 ***Question 4: Should special provision be made for assignments of shares in companies? If so, would it be satisfactory to apply the law governing the share agreement, normally that of the habitual residence of the company? If so, should there be a further exception to the proposed paragraph 3(b) under which shares are also excluded from the rule in that paragraph?***

5.1.1 The FMLC's position is that there should not be special provision for any transfer of shares. However, Article 1(2)(f) should be amended to clarify that the rights and obligations of shareholders and the transfer of shares fall outside the scope of Rome I Regulation.

6 Letters of credit

6.1 ***Question 5: Is it necessary to make special provision for letters of credit? Should letters of credit be excluded from the rule in paragraph 3(b)?***

6.1.1 It is not necessary to make special provision for letters of credit. Although it is hardly necessary to exclude letters of credit from paragraph 3(b), since they are normally issued by banks in favour of corporate entities, it is preferable to retain an express exclusion on the grounds that the consumer exception is difficult to justify and its scope should be curtailed as far as possible (other than in relation to those financial instruments for which the exception is deemed politically essential).

6.2 ***Question 6: Should there be a further exception to the proposed paragraph 3(b) under which insurance policies are also excluded from the rule in that paragraph?***

6.2.1 Yes, there should be a further exception for insurance policies as it is common for consumers to assign their rights in relation to such policies. Moreover, by expressly stating that insurance policies are excluded from paragraph 3, the consumer exception is drafted as narrowly as possible.

7 Tort or delict claims

7.1 ***Question 7: Should the proposed paragraph 3 apply to the subrogation (both by operation of law and under a contract) and assignment of claims in tort? If so, should the applicable law be determined by the general rules or is special provision necessary?***

7.1.1 It would be preferable for Article 14 to apply to non-contractual obligations, and for the applicable law to be determined by the general rules.

8 Conclusions

8.1 The FMLC acknowledges the difficulties of reaching a compromise on the issue of the effectiveness of assignment against a third party and in adopting the *lex contractus* as the exclusive rule for assignment or subrogation.

8.2 The UK compromise appears to be acceptable to the extent that the exceptions to the *lex contractus* rule are kept as narrow as possible, and that the super-conflict rule identifies the *lex contractus* as the prevailing rule over the law of the assignor's residence.

8.3 Transfer of shares should fall outside Rome I Regulation. It does not seem particularly necessary to make special provisions for letters of credit although it is essential that insurance policies are excluded from the consumer exception contained in paragraph 3.

8.4 Finally, it is important to clarify whether the assignment of a non-contractual obligation falls within the scope of Article 14 and, in any case, to identify the rules applicable to it.