

October 2006

FINANCIAL MARKETS LAW COMMITTEE

**ISSUE 121 – EUROPEAN COMMISSION FINAL PROPOSAL FOR
A REGULATION ON THE LAW APPLICABLE TO
CONTRACTUAL OBLIGATIONS (“ROME I”)**

Suggestions for amendments to Articles 7 and 13

Financial
Markets
Law
Committee

c/o Bank of England
Threadneedle Street
London EC2R 8AH
www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 121 WORKING GROUP

William Blair QC	3 Verulam Buildings
Michael Brindle QC	Fountain Court Chambers
Andrew Dickinson	Clifford Chance LLP
Richard Fentiman	University of Cambridge
Simon Gleeson	Allen & Overy LLP
Christopher Harris	3 Verulam Buildings
Mark Huleatt-James	Lovells
Ed Murray	Allen & Overy LLP
Will Robinson	Freshfields Bruckhaus Deringer
David Sandy	Simmons & Simmons
Monique Sasson	
Matthew Weiniger	Herbert Smith LLP
Joanna Perkins	Secretary, FMLC
Stephen Parker	Legal Assistant, FMLC
Joe Wood	Legal Assistant, FMLC
Kate Morris	Legal Assistant, FMLC

Introduction

The role of the Financial Markets Law Committee (“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.

In September 2006 the Department for Constitutional Affairs (“DCA”) and HM Treasury (“HMT”), having previously sought the views of the FMLC on the substance of the European Commission’s Final Proposal for a Regulation on the law applicable to contractual obligations (known as the “Rome I” Regulation) (the “Commission’s Final Proposal”),¹ approached the Committee for comments on the drafting of Articles 7 and 13 of the Commission’s Final Proposal. This paper responds to that request and sets out the FMLC’s suggested drafting changes with explanatory comments.

The FMLC is grateful to Richard Fentiman (University of Cambridge) and Andrew Dickinson (Clifford Chance) who have contributed to this paper. A list of those advising the FMLC on the Commission’s Final Proposal more generally appears at the front of this paper.

The fact that this paper considers only Articles 7 and 13 should not be taken in any way to indicate that the FMLC is content with other articles put forward in the Commission’s Final Proposal or in any drafts produced subsequently by/for the European Commission, Council or Parliament.

Article 7

Commission Text

The Commission’s Final Proposal contains the following text for Article 7:

Article 7 – Contracts concluded by an agent

1. In the absence of a choice under Article 3, a contract between principal and agent shall be governed by the law of the country in which the agent has his habitual residence, unless the agent exercises or is to exercise his main activity in the country in which the principal has his habitual residence, in which case the law of that country shall apply.
2. The relationship between the principal and third parties arising out of the fact that the agent has acted in the exercise of his powers, in excess of his powers or without power, shall be governed by the law of the country in which the agent had his habitual residence when he acted. However, the applicable law shall be the law of the country in which the agent acted if either the principal on whose behalf

¹

COM (2005) 650 final

he acted or the third party has his habitual residence in that country or the agent acted at an exchange or auction.

3. Notwithstanding paragraph 2, where the law applicable to a relationship covered by that paragraph has been designated in writing by the principal or the agent and expressly accepted by the other party, the law thus designated shall be applicable to these matters.

4. The law designated by paragraph 2 shall also govern the relationship between the agent and the third party arising from the fact that the agent has acted in the exercise of his powers, in excess of his powers or without power.

Comments

Article 7 governs contracts concluded with or through an agent, including contracts entered into by a company acting through one of its officers or employees, and the rules it sets out are therefore key for virtually all types of commercial contract.

These provisions are entirely new and, in the FMLC's view, not within the scope of a transposition and modernisation exercise, which is the declared objective of the Commission's Final Proposal.² Further, the private international law rules laid down Article 7, which generally subject matters relating to agency, including questions of authority, to the law of the agent's habitual residence, disclose a number of problems.

Firstly, the rules are unduly protective of the interests of the agent as opposed to those of the contracting third party. The rights and obligations of the third party vis-à-vis the principal (including the question of whether the principal is bound by the contract at all) should be easily ascertainable by the third party. Thus, the law governing the rights and obligations of the third party should also be easily ascertainable. However, the third party may not easily be able to discover the habitual residence of the agent and ascertaining the position under that country's system of law will add significantly to his costs.

Secondly, in most cases, besides that of a commercial agent of the type more commonly found in other European jurisdictions, the habitual residence of an agent is irrelevant. (The FMLC has considered, for example, the case of a company employee or officer acting beyond his actual authority. The habitual residence of the employee or officer, if not also the location of the employer, seems largely arbitrary.) This characteristic has caused the FMLC to speculate whether the Article was, at source, intended to be limited to commercial agents and has been extended beyond this case either inadvertently during drafting or, at least, without proper consideration of the issues involved.

Solutions and Drafting

The ideal solution to the problems posed by Article 7 would be the deletion of the provision as a separate article, if necessary accompanied by a revision to Article 4 to cover contracts between principal and agent which contain no express choice of law clause. (In this regard, it should be noted that in its April 2006 paper on the

²

See section 2 of the Commission's Final Proposal.

Commission's Final Proposal,³ the FMLC recommended that the sub-rules in paragraphs (1) and (2) of Article 4 should be reformulated as general presumptions subject to the overriding rule that a contract is to be governed by the system of law with which it is most closely connected.)⁴

If, however, Article 7 is to remain in some form, it is probable that a similar result can be achieved by redrafting Article 7(1) and deleting Articles 7(2) and 7(3). In which case, Article 7(4) should be deleted or redrafted carefully, taking into account the point that the relationship between agent and third party is not necessarily, or usually, contractual.

Following these guidelines, the Article might appear as follows:

Article 7(1), (2) and (3) bis (no further subparagraphs)

1. In the absence of a choice under Article 3, it shall be presumed that a contract for the performance of agency functions is governed by the law of the country in which the agent has his habitual residence at the time of contracting, unless the contract provides that the agent is substantially to perform his functions in another country, in which case the law of that country shall be presumed to apply.
2. It shall be presumed that any contract between the agent and a third party arising from the fact that the agent has acted in the exercise of his powers, in excess of his powers or without authority is governed by the law of the country in which the agent has his habitual residence at the time of acting, unless the agent acted in the country in which the third party has his habitual residence, or at an exchange or auction, in which case the law of the country where he acted shall be presumed to apply.
3. The presumptions set out in paragraphs 1 and 2 shall be disregarded if it is clear from all the circumstances that the contract is manifestly more closely connected with another country, in which case the law of that country shall apply. In determining such a connection for the purposes of paragraph 2, regard shall be had in particular to the terms of any contract which the agent entered or purported to enter into in the exercise of his powers, including an express choice of law.

An additional provision in Article 1(2), reinstating Article 1(2)(f) of the Rome Convention, could then make it absolutely clear that Article 7 does not govern the questions relating to the authority of the agent, whether actual or ostensible, as follows:

Article 1(2)(fa)

[The Regulation shall not apply to] the question whether an agent is able to bind a principal to a third party.

Alternatively, but not optimally, if it is thought necessary to have a rule governing issues of authority, including the relationship that may arise between the principal and a third party from the exercise of that authority, the rule should subject these questions primarily to the law applicable to the contract concluded between the agent and the third party.

³

Available at www.fmlc.org

⁴

At paragraph 6.10.

Article 7(4) bis

4. The question whether a contract concluded by an agent with a third party is binding on the principal shall be determined by the law which would govern that contract under this Regulation if the contract were binding on the principal,⁵ *provided that whether the principal authorised the agent to enter into the contract shall be governed by the law applicable to any contract between principal and agent.**⁶

It seems right that the questions about the extent of the agent's ostensible authority should be governed by the law under which the agent contracts, or purports to contract, with the third party on the principal's behalf. This rule allows the third party to determine the extent of the agent's ability to bind his principal with relative clarity and corresponds to the ordinary requirements of commercial transactions. There is no role for a rule that subjects questions about the relationship between the principal and a third party to a system of law that relates only to the personal circumstances of the agent. On the other hand a rule that subjects these questions to a system of law that relates to the circumstances of the principal could be seen as opaque and oppressive to the third party.

There is, however, some argument that, as a matter of principle, questions about the extent of an agent's actual authority should be governed by the law applicable to the relationship between the agent and the principal. Generally, since a determination that the agent has no actual authority will, in any case, always beg the question whether he has ostensible authority, it does not seem necessary to reserve the earlier question to a different system of law. However, there is the possibility that the third party may wish to rely on the actual authority of the agent arising under a law other than that applicable to the contract which he negotiated with the agent and so the words in italics have been added to the drafting above in order to provide for this option.

⁵ An application of the putative proper law of the contract in line with Art. 8.1 of the Rome Convention.

⁶ Alternatively the words in italics may be replaced by the following:

provided that,

- (a) *whether the principal authorised the agent to enter into the contract shall be governed by the law applicable to any contract between principal and agent*; and*
- (b) *the principal may rely upon the law applicable to his relationship with the agent* to establish that he did not consent if it appears from the circumstances that it would not be reasonable to determine the effect of the agent's conduct in accordance with the law specified in this paragraph.*

Subparagraph (b) is an optional addition intended to give limited protection to the principal in circumstances where the agent concludes a contract with a third party under a system of law with an overly wide rule on ostensible authority. Whether this option is adopted will depend on the view taken of the competing merits of the respective needs of the principal and the third party for protection in cases where an agent exceeds his authority.

* In consideration of the fact that a relationship of principal and agent may arise other than by contract, the words "whether or not determined in accordance with the provisions of this Regulation" may be inserted for the sake of clarity, as appropriate.

Article 13(3)

Commission Text

The Commission's Final Proposal contains the following text for Article 13:

Article 13 – Voluntary assignment and contractual subrogation

1. The mutual obligations of assignor and assignee under a voluntary assignment or contractual subrogation of a right against another person shall be governed by the law which under this Regulation applies to the contract between the assignor and assignee.
2. The law governing the original contract shall determine the effectiveness of contractual limitations on assignment as between the assignee and the debtor, the relationship between the assignee and the debtor, the conditions under which the assignment can be invoked against the debtor and whether the debtor's obligations have been discharged.
3. The question whether the assignment or subrogation may be relied on against third parties shall be governed by the law of the country in which the assignor or the author of the subrogation has his habitual residence at the material time.

Comments

Article 13 deals with the assignment of intangibles, including financial instruments, and is therefore a key provision for the wholesale financial markets.

Article 13(3) arguably ignores the important principle of debtor protection.⁷ It is important for a debtor to know whom to pay the required sum in order to discharge the debt (or, to put it another way, who now stands in a relationship of privity with him such that that person is entitled to sue him). To get to this point it is important that he knows who owns the debt and that, in turn, he is capable of answering the question of the priority of competing assignments of the debt and capable of identifying the law governing that question. In principle, either the *lex contractus* (the law of the contract creating the debt and that identified under Article 13(2)) or the *lex situs* (the law of the debtor's residence) achieve this, but the law of the assignor's residence does not.⁸

Article 13(3) will also significantly add to costs in many transactions. An assignee of a debt must consider issues arising under the applicable law of the contract of assignment, the *lex contractus* or applicable law of the contract creating the debt and, now, the law of the assignor's habitual residence before he can know his rights.

⁷ In contrast, notably, to the UNCITRAL Receivables Convention on which the Commission claims to have based Article 13(3).

⁸ It is sometimes said that the question of to whom the debtor should make payment is different from the question of who has the right to the debt and that, while the former question can and should be governed by Article 13(2), the latter should be reserved to a different rule under Article 13(3). However, *Dicey and Morris* are of the view that the two questions are difficult, if not impossible, to disentangle (see paragraph 24-059) and this also appears to have been the view of the Court of Appeal in *Raiffeisen Zentralbank Österreich AG v Five Star Trading LLC* [2001] QB 825.

Solutions and Drafting

The simplest and most elegant solution is to allow the law identified under Article 13(2) to apply also to those matters which are the subject of Article 13(3). This might be achieved as follows:

Article 13(3) bis (no further subparagraphs)

(3) 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.

Alternatively, if the rule currently proposed in Article 13(3) is to remain, it must be made absolutely clear (by means of a recital or amendment to the text) that Article 13(3) shall not affect the obligations of the debtor, including (in particular) any question whether a payment by the debtor has discharged the debt.

Conclusion

The FMLC's conclusion is that Articles 7 and 13, as presented in the Commission's Final Proposal, present significant problems and contravene accepted commercial principles in important ways. Because these articles are likely to play a significant role in financial markets contracts, in particular, as well as in commercial contracts more generally, the FMLC is of the view that seeking the drafting amendments set out in this short paper should be a priority for those contributing to the process of legislating for a Rome I Instrument.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS

Lord Woolf, Chairman

Bill Tudor John, Lehman Brothers

Peter Beales, LIBA

Dr Joanna Benjamin, London School of Economics & Political Science

Michael Brindle QC

Keith Clark, Morgan Stanley International

Sally Dewar, Financial Services Authority

Ruth Fox, Slaughter and May

Mark Harding, Barclays

Sally James, UBS Investment Bank

Clive Maxwell, HM Treasury

Guy Morton, Freshfields Bruckhaus Deringer

Habib Motani, Clifford Chance LLP

Ed Murray, Allen & Overy LLP

Steve Smart, AIG

Paul Tucker, Bank of England

Secretary: Joanna Perkins, Bank of England