Global custody: an English law analysis.

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GLOBAL CUSTODY

AN ENGLISH LEGAL ANALYSIS

Joanna Benjamin

PhD Thesis

King’s College, London

1996
Global custody is a service whereby a single custodian holds its client's international portfolio through a network of local sub-custodians, clearing systems and depositaries. Modern custodial practice is electronic and cross border. The lack of a tangible and allocated subject matter cuts across the traditional characterisation of custody as bailment. Ambiguities as to the location of custody assets raises novel questions of conflict of laws.

It is argued that computerised debt securities are not negotiable instruments, but that the benefits of negotiability are available by other means, in particular the rules of equity and of private international law. It is argued that the impact of computerisation of registered securities is more limited, due to the historically intangible and unallocated nature of company shares.

Traditionally, the custodian is a bailee in resect of securities, and a bank debtor in respect of cash. It is argued that because computerised custody securities are intangible and fungible, the custodian is not a bailee but a trustee.

Where the securities of different clients are commingled, the difficulty in showing certainty of subject matter for a valid trust is discussed. It is suggested that commingled clients should be treated as equitable tenants in common.

Principles of private international law are discussed in relation to global custody generally, negotiability, taking security and custodian insolvency.

The fiduciary duties of the custodian are considered in the light of recent case law.

It is concluded that the uncertainties raised by the electronic and cross-border nature of global custody may largely be addressed by greater use of the principles of the law of trusts, and careful drafting in customer documentation.
# TABLE OF CONTENTS

Chapter 1. Introduction .................................................. 1
  1. The Global Network ................................................ 1
  2. The Service ......................................................... 1
  3. The Participants ................................................... 2
  4. Uncertainty ......................................................... 3
  5. Analytic Context .................................................. 3
  6. Scope ............................................................... 4

Chapter 2. English domestic law principles .......................... 5
  1. Assets, Possession and Property .................................... 5
     a. Assets .......................................................... 5
     b. Possession ...................................................... 5
     c. Property ......................................................... 6
     d. Legal Relationships ............................................ 6
     e. Property is relative ........................................... 6
     f. Possession and Property as Remedies .......................... 8
     g. Categories of Property ........................................ 10
     h. Summary: Personal Assets ..................................... 11
  2. Possession of Intangibles .......................................... 13
     a. legal possession ................................................ 13
     b. constructive possession ..................................... 13
     c. intangibles ..................................................... 14
     d. common law ..................................................... 16
     e. equity .......................................................... 16
  3. Proprietary and Personal Rights ................................... 17
     a. Generally ....................................................... 17
     b. Nature of choses in action ................................... 19
     a. Nature of Equitable Property .................................. 22
     b. Conclusions ..................................................... 23

Chapter 3. Computerisation and Securities .......................... 25

A. Computerised Securities ............................................. 26
  1. Immobilised Securities ............................................ 26
  2. Global Securities ................................................ 27
  3. Repackaged Securities ............................................. 28
  4. Dematerialised Securities ........................................ 28
B Bearer Computerised Securities

1. Negotiability

2. A new class of negotiable instrument?

3. Arguments against negotiability
   a. indirect
   b. intangible
   c. conclusion

4. Intermediate Securities
   a. functional status
   b. legal nature

5. The Benefits of Negotiability

6. Ease of Secondary Market Transactions
   a. Equitable estoppel
   b. Bare sub trust
   c. No disposition
   e. private international law

8. Conclusions

9. Taxation Consequences
   a. withholding tax
   b. stamp duty

10. Regulatory Consequences
    a. collective investment schemes
    b. balance sheet

11. General Conclusions

C. Registered Computerised Securities

1. Computerisation
   a. CGO
   b. CREST
   c. depositary receipts
   d. nature of Computerised Registered Securities
2. Intangible Nature of Traditional Registered Securities .......................... 93
3. Unallocated Nature of Traditional Registered Securities ...................... 94
   a. partnership ........................................................................ 94
   b. undivided share ................................................................... 95
   c. registered debt securities .................................................. 96
   d. no identity ......................................................................... 96
   e. numbering of shares .......................................................... 97
   f. fraudulent transfer cases ...................................................... 99
   g. contrast bearer securities ..................................................... 102
4. The Indirect Nature of Traditional Registered Securities ...................... 102
   a. Repackaged Securities ....................................................... 102
   b. equity .............................................................................. 102
5. Summary ................................................................................. 103
6. Debentures .............................................................................. 104
7. Fraudulent Transfers .................................................................... 105

D. Conclusions - Bearer and Registered Securities ................................. 109
   1. Generally ........................................................................... 109
   2. Registered and Bearer Securities ........................................... 109

Chapter 4. Computerisation and the custody relationship ........................... 111
   1. The Traditional View ......................................................... 111
   2. Cash ................................................................................. 111
      a. The Debtor/Creditor Principle ........................................ 111
      b. Trust Over Cash ............................................................ 112
      c. Deposit-taking business .................................................. 113
   3. Securities ............................................................................ 114
      a. Ownership ...................................................................... 115
      b. Possession ..................................................................... 116
      c. Fungible Custody and Equivalent Redelivery .................. 117
      d. Summary ........................................................................ 120
      f. custodian trustees .......................................................... 121

Chapter 5. The Allocation problem ......................................................... 122

A. Identity in Securities .................................................................... 122
B. The Allocation Problem .................................................................. 123
   1. Loss of Property Risk ......................................................... 123
a. Credit Risk of Custodian ......................................................... 124
b. Other Risks ........................................................................... 124
d. Charging Custody Securities ................................................ 126

2. The Cases ............................................................................... 126
   a. Re London Wine (Shippers) Ltd. ........................................... 127
   b. In re Stapylton Fletcher Ltd. ................................................ 127
   c. Re Goldcorp Exchange Ltd. (in receivership) ....................... 128

C. Physical Bearer Securities .......................................................... 130
   1. Timing ................................................................................ 131
      a. two lines of cases .......................................................... 131
      b. Commingling .................................................................. 132
      c. Old and New Custody Securities ..................................... 133
   2. Tenancy in Common ............................................................. 134

D. Registered Securities .................................................................. 137
   1. The impossibility of Allocation ........................................... 137
   2. Old Securities ..................................................................... 137
   3. New Securities ................................................................... 140
   4. Akin to Cash ...................................................................... 141
      a. entire account ............................................................... 141
      b. no account .................................................................. 141
      c. ex bulk ....................................................................... 143
   5. Equitable Charge .................................................................. 145
   6. Trust Interest ..................................................................... 147
   7. Conclusions - Registered Securities ................................... 149

E. Conclusions .............................................................................. 149

Chapter 6. English Private International law ...................................... 150

A. General .................................................................................. 150
   1. Legal Uncertainty ............................................................. 150
   2. Cash and Securities .......................................................... 151
   3. Approach of the courts ...................................................... 152
B. Jurisdiction .................................. 152
   1. The Act .................................. 153
      a. scope .................................. 153
      b. domicile ................................ 154
      c. non-exclusive jurisdiction .............. 154
      d. exclusive jurisdiction .................... 156
      e. Summary ................................ 157
   2. General Law ................................ 158
      a. present in England ....................... 158
      b. submission ................................ 159
      c. leave to serve writ outside the jurisdiction . . 159
   3. Loss of Jurisdiction .......................... 161

C. Choice of Law; General Principles .................. 163
   1. The Issue ................................ 163
   2. Approach ................................ 163
      a. categories and connecting factors ............. 163
      b. terms ................................ 164
   2. Approach to Foreign Law ...................... 164
   3. Renvoi ................................ 164

D. Integrity of Transfer .............................. 165
   1. Jurisdiction ................................ 166
   2. Categorisation ................................ 166
      a. Undestroyed Proprietary Base ............... 167
      b. Dearle v Hall ............................ 168
      c. Tracing ................................ 168
   3. Statute ................................ 169
      a. The Rome Convention ....................... 169
      b. Contractual and Proprietary Aspects ......... 170
      c. Different Proprietary Relationships ......... 171
   4. Case law ................................ 172
   5. Lex Situs ................................ 172

E. Formalities of Transfer ............................ 173
   1. Jurisdiction ................................ 173
   2. Substance and Procedure ...................... 174
   3. Categorisation ................................ 176
4. Formal Validity ..................................... 176
5. Mandatory Rules .................................... 177

F. Negotiability ..................................... 179
1. Jurisdiction ..................................... 179
2. Traditional Bearer Securities ................ 180
3. Transaction not instrument ................. 180
4. Computerised Bearer Securities .............. 181
   a. The problem of categorisation ............ 181
   b. situs of intangible ..................... 182
   c. lex loci actus ......................... 183
5. Conclusions ..................................... 183

Chapter 7. Cross Border Proprietary Rights:
Taking Security and Insolvency .................... 185

A. General ..................................... 185

B. Nature of Property Interest ..................... 186

C. Taking Security ................................ 187
   1. Generally ................................ 187
   2. What law will govern? ..................... 188
      a. problem with local jurisdiction 188
      b. intermediary jurisdiction 188
      c. defence of security interest .... 189
   3. Attachment ................................ 190
      a. managed collateral ............... 190
      b. English law ....................... 193
   4. Perfection ................................ 194
      a. generally ......................... 194
      b. English law ....................... 195
   5. Priorities ................................ 195
      a. generally ......................... 195
      b. English law ....................... 196
   6. Intermediary Jurisdiction Approach ........ 196
      a. lex situs ......................... 197
      b. intangibles and securities ....... 198
      c. interest under a trust ........... 198

3. Particular Clauses ........................................ 236
   a. *force majeure* ...................................... 236
   b. *consequential damages* ............................ 237

C. Liability for Third Parties ............................. 237
   1. Liability for Sub-Custodians ....................... 237
   2. Fraudulent Instructions ............................. 240
      a. *Bank America Writ* .............................. 240
      b. *Galmerrow* ..................................... 241
      c. *Goode Report* .................................. 242
      d. *conclusions* ................................... 242

D. Secret Profits .......................................... 243

E. Conflicts of Interest .................................... 244

F. Consequences of Breach of Duty ....................... 245
   1. Breach of Fiduciary Duty ........................... 246
   2. Negligence ......................................... 247
   4. Nexus ............................................. 249
   5. Indemnities for Breach of Duty .................... 249

Chapter 9. Conclusions ..................................... 250
<table>
<thead>
<tr>
<th>Case Title</th>
<th>Year</th>
<th>Page Numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. G. for Hong Kong v Reid</td>
<td>[1993]</td>
<td>23, 201</td>
</tr>
<tr>
<td>A. G. v Jewish Colonisation Association</td>
<td>[1901]</td>
<td>200</td>
</tr>
<tr>
<td>A. G. v Johnson</td>
<td>[1907]</td>
<td>199</td>
</tr>
<tr>
<td>Alcock v Smith</td>
<td>[1892]</td>
<td>180, 181, 194</td>
</tr>
<tr>
<td>Alliance &amp; Leicester Building Society v Ghahremani and Others</td>
<td>(1992)</td>
<td>41</td>
</tr>
<tr>
<td>Aluminium Industrie Vaassen B.V v Romalpa Aluminium</td>
<td>[1976]</td>
<td>138</td>
</tr>
<tr>
<td>Archer-Shee v Garland</td>
<td>[1931]</td>
<td>204</td>
</tr>
<tr>
<td>Ashby v Blackwell and the Million Bank, Amb.503 (Chancery, 1765)</td>
<td></td>
<td>106</td>
</tr>
<tr>
<td>Austen v Graham</td>
<td>(1899)</td>
<td>33</td>
</tr>
<tr>
<td>B. R. S. Ltd. v Arthur V. Crutchley Ltd</td>
<td>(1968)</td>
<td>230</td>
</tr>
<tr>
<td>Baker v Archer-Shee (H.L.) [1927]</td>
<td></td>
<td>11, 12, 164, 201, 202</td>
</tr>
<tr>
<td>Bank of Baroda, Ltd. v Punjab National Bank, Ltd.</td>
<td>[1944]</td>
<td>36</td>
</tr>
<tr>
<td>Bank of Ireland v Evans Charities Trustees</td>
<td>(1855)</td>
<td>107</td>
</tr>
<tr>
<td>Bankers Trust international Ltd. v Todd Shipyards Corp. (The Halcyon Isle)</td>
<td>[1988]</td>
<td>196</td>
</tr>
<tr>
<td>Banque des Marchands de Moscou (Koupetschesky) v Kindersley</td>
<td>(1951)</td>
<td>220</td>
</tr>
<tr>
<td>Barclays Bank Ltd. v Quistclose Investments Ltd.</td>
<td>[1968]</td>
<td>24, 145</td>
</tr>
<tr>
<td>Barlow Clowes v Vaughan</td>
<td>[1992]</td>
<td>82, 83, 222</td>
</tr>
</tbody>
</table>
Barton v London & NW Ry Co (1888) ...................................................... 107

Bechuanaland Exploration Co. v London Trading Bank [1898] .................. 33, 36, 181

Bence v Shearman [1898] ................................................................. 73

Benticle v London Joint Stock Bank [1893] ........................................ 33

Berkeley Applegate (Investment Consultants) Ltd ..................................... 216, 223

Bishopsgate Investment Management Ltd (in liq) v Maxwell (No 2) [1994] ....... 246

Bishopsgate Investment Management v Homan [1994] .............................. 84, 140

Bligh v Brent (1836) ............................................................................. 70

Borden Chemical Co (Canada) Ltd v J.G. Beukers Ltd [1973] ..................... 15

Borland's Trustee v. Steel Brothers & Co Limited [1901] ............................. 93, 94

Boscawen v Bajwa [1995] ................................................................. 23

Brady v Stapleton [1952] ...................................................................... 98

Bray v Ford (1986) ............................................................................... 243, 245

Braybrooke v A.G. ............................................................................. 63

Brice v Bannister (1878) ..................................................................... 143

Brickenden v London and Loan Savings Co [1934] ................................... 246

Brinks Ltd v Abu-Saleh and Others (No 3) (1995) .................................... 247

Bristol and West Building Society and May May & Merrimans [1996] .......... 246

Brown v Davies [1789] ...................................................................... 31

Buckley v Gross (1863) ...................................................................... 132, 138
<table>
<thead>
<tr>
<th>Case</th>
<th>Year</th>
<th>Page(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building &amp; Civil Engineering Holidays Schemes Management Ltd v Post Office</td>
<td>1969</td>
<td>15</td>
</tr>
<tr>
<td>Bullard v Bell (1817)</td>
<td></td>
<td>59</td>
</tr>
<tr>
<td>Carlos Federspiel &amp; Co. S.A. v Charles Twigg &amp; Co. Ltd.</td>
<td>1957</td>
<td>123</td>
</tr>
<tr>
<td>Carne v Long (1860)</td>
<td></td>
<td>65, 66</td>
</tr>
<tr>
<td>Carr v. Carr (1811)</td>
<td></td>
<td>111</td>
</tr>
<tr>
<td>Chief Constable of Kent v V and Another [1982]</td>
<td></td>
<td>15</td>
</tr>
<tr>
<td>Chinn v Collins [1981]</td>
<td></td>
<td>55, 57</td>
</tr>
<tr>
<td>Cholmondeley v IRC (1986)</td>
<td></td>
<td>12</td>
</tr>
<tr>
<td>Cia Colombiana de Seguros v Pacific Steam Navigation Co.</td>
<td>1965</td>
<td>177</td>
</tr>
<tr>
<td>Clark Boyce v Mouat [1994]</td>
<td></td>
<td>233</td>
</tr>
<tr>
<td>Clarke v Dunraven [1897]</td>
<td></td>
<td>80</td>
</tr>
<tr>
<td>Cock v Manners (1871)</td>
<td></td>
<td>66</td>
</tr>
<tr>
<td>Coggs v Bernard (1703)</td>
<td></td>
<td>6, 114</td>
</tr>
<tr>
<td>Coleman v. Harvey (1989)</td>
<td></td>
<td>133</td>
</tr>
<tr>
<td>Coles v Bank of England (1839)</td>
<td></td>
<td>107</td>
</tr>
<tr>
<td>Collins v Martin (1797)</td>
<td></td>
<td>7, 39</td>
</tr>
<tr>
<td>Colonial Bank v Cady (1890)</td>
<td></td>
<td>78, 79, 182</td>
</tr>
<tr>
<td>Colonial Bank v Whinney (1885)</td>
<td></td>
<td>10, 93</td>
</tr>
<tr>
<td>Commissioner for Stamp Duty v Livingston [1965]</td>
<td></td>
<td>12, 202</td>
</tr>
<tr>
<td>Concorde Construction Co. Ltd. v Colgan Ltd. (1984)</td>
<td></td>
<td>142</td>
</tr>
</tbody>
</table>
Conservative and Unionist Central Office v Burrell [1982] .................. 64
Coudian v Nadler [1979] .................................................. 220
Crouch v the Credit Foncier Co (1873) ................................. 36, 37, 42
Crowther v Elgood, (1882) ................................................ 15
Customs and Excise Comrs v Guy v Butler (International) Ltd [1977] ... 33
Davis v. Bank of England (1824) ......................................... 76, 99, 106
Dearle v Hall [1824-34] ................................................... 73, 76, 101, 167, 168
Derby & Co Ltd v Weldon (No 9) [1991] ................................. 41
Devaynes v Noble, Clayton's Case (1816) ............................... 82, 138
Durham Brothers v Robertson [1898] ................................... 143
Earl of Setland v Lord Advocate ............................................ 63
Edelstein v Schuler [1902] .................................................. 33
Edward v Hall (1855) ....................................................... 70
El Ajou v Dollar Land Holdings pcl and another [1993] ............... 81, 83, 168
Embiricos v Anglo-Austrian Bank [1905] ................................ 180, 194
Ex p Melbourne (1870) ..................................................... 196
Favorke v Steinkopff [1907] ................................................. 199, 200
First National Bank v Security (1892) .................................... 33
Fogg v School District (1878) ............................................... 33
Foley v. Hill (1848) ................................................................. 111
Friedlander v Texas (1889) ................................................. 39
Fry v Tapson (1884) .............................................................. 239
Galmerrow Securities Ltd & Ors v Nat. West Bank PLC 20 December 1990 ........... 235, 241
General Reinsurance Corporation and Others v Forsakringsaktiebolaget Fennia Patria (1983) ................................................................. 35
Glynwill Investments NV v Thomson McKinnon Futures Ltd (1992) ...................... 244
Goodwin v Robarts (1875) .......................................................... 33, 36, 37, 124, 125, 139
Gorgier v Mieville (1824) ................................................................ 33
Grainge v Wilberforce (1889) ......................................................... 47, 57
Grant v Southwestern and County Properties Ltd. [1974] ........................................ 41, 104
Grey v IRC [1958] ...................................................................... 57, 58, 61
Hagar v Buffalo ........................................................................... 33
Harding Corp. Ltd. v Royal Bank of Canada [1980] .............................................. 75
Harding v Commr of Inland Revenue [1977] ...................................................... 119
Harrison v Credit Suisse [1993] .......................................................... 164, 212, 213
Healey v Howlett & Sons [1917] ................................................................ 123
Hedley Byrne v Heller [1964] ................................................................ 248
Henderson v Merrett [1994] .................................................................. 234, 248
Higgs v Northern (1869) .................................................................. 33
Hill v R [1946] .............................................. 105
Holroyd v Marshall (1862) ........................................ 55
Holt v Dawson [1939] ........................................... 14
Hughes v Metropolitan Railway Co (1877) ........................................ 53
Hunter v Moss [1993] ........................................ 99, 127, 147
In re A.E.G. Unit Trust (Managers) Ltd. 's Deed. Midland Bank Executor & Trustee Co. Ltd. v A.E.G. Unit Trust Managers Ltd. [1957] ...................... 72
In re Bahia and San Francisco Pty Co ........................................ 76, 93, 95, 100, 106, 107
In re Brooke Bond & Co. Ltd. 's Trust Deed [1962] .............................. 229, 243
In re Cigala's Settlement Trusts (1878) ........................................ 199
In re Drummond, Ashworth v Drummond [1914] ................................ 66
In re Ellis, son & Vidler Ltd [1994] ........................................ 127
In re Lipinski's Will Trusts [1976] ........................................ 66
In Re Oatway, Hertslet v Oatway [1903] ........................................ 23, 82
In Re Oatway, Hertslet v Oatway [1903] ........................................ 23
In re Price [1943] ............................................... 66
In re Queensland mercantile and Agency Co [1891] .............................. 177, 196
In re Row, ex parte South (1818) ........................................ 143
In re Sharpe [1980] ............................................... 54
Lang v Smythe (1831) ........................................ 38, 180

Le Feuvre v Sullivan (1855) .................................... 196

Leahy v A.G. for New South Wales [1959] ...................... 66

Lee v Adby (1886) ............................................. 170

Leigh and Sillavan Ltd. v Aliakmon Shipping Cl. Ltd. ("The Aliakmon") [1986] ........ 18

Leroux v Brown (1852) ......................................... 175

Libyan Arab Foreign Bank v Bankers Trust Co [1988] ............... 33

Liggett v Kensington [1993] .................................... 128, 130

Livingstone v Rawyards Coal Co. (1880) ........................ 248

Lockyer v Gibb [1966] ........................................... 5

London and County Banking Company Ltd. v London and River Plate Bank Ltd. (1887) . 37, 41

London Joint Stock Bank v Simmons [1892] ........................ 37

Lord Sudeley v Attorney General [1897] ............................ 202, 203

Lupton v White (1808) ........................................... 132

Mac-Jordan Construction Ltd v Brookmount Erostin Ltd (in receivership) [1992] ... 7, 141, 148

Macmillan Inc v Bishopsgate Investment Trust PLC (No. 3) [1995] .. 74, 79, 164-166, 171, 172, 182, 195, 196, 206, 213

Marsh v Kulchar [1952] .......................................... 13

Marshall v Kerr [1994] ........................................... 12, 201, 202

-xvii-
<table>
<thead>
<tr>
<th>Case Description</th>
<th>Page Numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mercer v Craven (1995)</td>
<td>120</td>
</tr>
<tr>
<td>Micklefield v. S.A.C. Technology (1991)</td>
<td>236</td>
</tr>
<tr>
<td>Middleton v Chichester, (1871)</td>
<td>15</td>
</tr>
<tr>
<td>Midland Bank Trust (Jersey) Ltd v FPS (1995)</td>
<td>234, 235</td>
</tr>
<tr>
<td>Midland Ry Co v. Taylor (1862)</td>
<td>106</td>
</tr>
<tr>
<td>Miller v Race 1758</td>
<td>39, 42</td>
</tr>
<tr>
<td>Milroy v Lord [1861 - 73]</td>
<td>178</td>
</tr>
<tr>
<td>Motor Mart Ltd. v. Webb [1958]</td>
<td>120, 121</td>
</tr>
<tr>
<td>National Provincial Bank v Ainsworth [1965]</td>
<td>21, 75</td>
</tr>
<tr>
<td>Neste Oy v Lloyds Bank PLC (1993)</td>
<td>142</td>
</tr>
<tr>
<td>Neville Estates Ltd v Madden [1962]</td>
<td>64, 65, 67</td>
</tr>
<tr>
<td>Neville v Wilson [1996]</td>
<td>53, 58</td>
</tr>
<tr>
<td>Nicholson v Sedgwick (1690)</td>
<td>33</td>
</tr>
<tr>
<td>Northumberland v A.G [1905]</td>
<td>63</td>
</tr>
<tr>
<td>Oughtred v IRC [1960]</td>
<td>53, 55, 57</td>
</tr>
<tr>
<td>Palette Shoes v Krohn (1937)</td>
<td>55</td>
</tr>
<tr>
<td>Palmer v Carey [1926]</td>
<td>144, 145</td>
</tr>
<tr>
<td>Partridge v Bank of England (1846)</td>
<td>33</td>
</tr>
<tr>
<td>Pass v. Dundas (1880)</td>
<td>234</td>
</tr>
</tbody>
</table>
Pearson v IRC [1980] ....................................................... 12, 16

Phillipson-Stow v I.R.C. [1961] ............................................. 204

Picker v London and Country Banking Co (1887) ......................... 180

Pilcher v. Rawlins (1872) .................................................. 74

Platt v. Rowe (1909) ....................................................... 98, 99

R V Boyesen [1892] ......................................................... 13

R v Gomez [1993] .......................................................... 6

R v Martin [1948] .......................................................... 14

Ralli Bros v Sota y Aznar [1920] ......................................... 178

Rayak Construction v Lampeter Meat Co. Ltd. (1979) ..................... 142

Re a Company (No. 00359 of 1887) ("Okeanos") [1988] .................... 220


Re Agra & Masterman's Bank (1867) .................................... 33, 77

Re Anziani [1930] .......................................................... 170

Re Asoff-Don Commercial Bank (1984) .................................. 220

Re Berchtold [1923] ......................................................... 204

Re Brier, (1884) .......................................................... 238, 239

Re Bucks Constabulary (No 2) [1979] ................................ 64

Re Central Bank (1889) ................................................... 33

Re Chapman [1896] ......................................................... 238
Re Commercial Bank (1897) .......................................................... 33

Re Companie Merabello San Nicholas S.A. (1973) ................................................. 220

Re Conveyances, Abbott v Treasury Solicitors and others [1969] ......................... 66

Re Diplock [1948] ................................................................................. 139

Re Eastern Capital Futures (in liq.) [1989] ...................................................... 82

Re Eloc Electro-Optiecka and Communicatie BV [1982] ....................................... 220

Re Fry [1946] .................................................................................. 177, 178, 193

Re General Estates (1868) ........................................................................ 33

Re Goldcorp Exchange Ltd (in receivership) [1994] ........................................ 18, 49, 84, 128, 129, 131, 135, 139, 140, 147, 227, 234

Re Grant’s Will Trust [1979] ....................................................................... 67

Re Hallet & Co. [1894] ............................................................................. 140

Re Hallett’s Estate, Knatchbull v Hallett [1874 - 80] ...................................... 82, 83, 112, 114, 138

Re Harrods (Bueros Aires) Limited [1992] ......................................................... 162

Re ILG Travel Ltd [1995] .......................................................................... 145

Re Imperial Land Co (1870) ......................................................................... 33

Re Jartay Development Ltd. (1983) .................................................................. 142

Re Kayford Ltd. [1975] ............................................................................... 24

Re Lashmar ............................................................................................... 56

Re Leven (Earl)(Decd), Inland Revenue Comrs v Williams Deacon’s Bank Ltd [1954] ... 62

Re Matheson Brothers Limited (1884) ........................................... 220

Re Nanwa Gold Mines Ltd [1955] ............................................. 141


re Ottos Kopje Diamond Mines Ltd [1893] .................................. 100, 107

Re the International Contract Company (1872) ................................ 97

Re V G M Holdings Limited 1 Ch [1942] ........................................ 93

Re Vandervell's Trusts (No 2) [1974] .......................................... 53, 78

Re Vickery (1931) ................................................................. 238

Re Waterman's Will Trusts [1952] ........................................... 231

Re: Andrabell Ltd (in liquidation), Airborne Accessories Ltd [1984] ............ 229

Reading v Attorney General [1949] ............................................ 229

Regazzone v Sethia [1958] ...................................................... 178

Republica de Guatemala v Nunez [1927] .................................... 175, 177, 196

Rochefoucauld v BouSteam [1871] ............................................. 53, 174

Rodick v Gandell (1852) ......................................................... 144, 145

Roscoe v Winder [1915] ............................................................ 147

Rossano v Manufacturers Life Insurance Co. [1963] ................................ 178

Royal Brunei Airlines [1995] ..................................................... 241, 247

Royal Exchange Assurance Corp v Vega [1901] ................................ 175
<table>
<thead>
<tr>
<th>Case</th>
<th>Volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rumball v Metropolitan (1877)</td>
<td>33</td>
</tr>
<tr>
<td>Sauce v Exchange (1894)</td>
<td>33</td>
</tr>
<tr>
<td>Secretary of State for India v. Bank of India Ltd [1938]</td>
<td>108</td>
</tr>
<tr>
<td>Sen v Headley [1991]</td>
<td>14</td>
</tr>
<tr>
<td>Sheffield Corpn v. Barclay, HL (1904-7)</td>
<td>108</td>
</tr>
<tr>
<td>Siebe Gorman v Barclays [1979]</td>
<td>147</td>
</tr>
<tr>
<td>Simm v Anglo-American Telegraph Co. (1879)</td>
<td>76, 101, 107</td>
</tr>
<tr>
<td>Simmons v London Joint Stock Bank [1891]</td>
<td>33</td>
</tr>
<tr>
<td>Sinclair v Brougham, (1914)</td>
<td>7</td>
</tr>
<tr>
<td>Sloman v Bank of England (1845)</td>
<td>107</td>
</tr>
<tr>
<td>Societe Generale de Paris v Walker (1885)</td>
<td>30</td>
</tr>
<tr>
<td>South Australian Insurance Co v. Randell [1869]</td>
<td>111, 118</td>
</tr>
<tr>
<td>Space Investments Ltd v. Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd [1986]</td>
<td>112, 139, 140</td>
</tr>
<tr>
<td>Speight v Gaunt (1883)</td>
<td>231, 238</td>
</tr>
<tr>
<td>Spence v. Union Marine Insurance (1868)</td>
<td>131, 132</td>
</tr>
<tr>
<td>Spiliada Maritime Corp v Consulex (1987)</td>
<td>162</td>
</tr>
<tr>
<td>Standen v Licensing Control Commission [1990]</td>
<td>104</td>
</tr>
<tr>
<td>Stanley Yeung Kai Yung v. Hong Kong and Shanghai Banking Corpn [1981]</td>
<td>108</td>
</tr>
</tbody>
</table>

- xxii -
<table>
<thead>
<tr>
<th>Case</th>
<th>Page Numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steele v Wellcome Trustees Ltd [1988]</td>
<td>238</td>
</tr>
<tr>
<td>Swan v NBA (1863)</td>
<td>31</td>
</tr>
<tr>
<td>Swiss Bank Corp v Lloyds Bank [1979]</td>
<td>23, 117, 139, 144, 146</td>
</tr>
<tr>
<td>Target Holdings Ltd v Redfens [1995]</td>
<td>233, 237, 246</td>
</tr>
<tr>
<td>The Colorado [1923]</td>
<td>196</td>
</tr>
<tr>
<td>The Duke of Newcastle v Kinderley (1803)</td>
<td>133</td>
</tr>
<tr>
<td>The Tagus [1903]</td>
<td>196</td>
</tr>
<tr>
<td>Thompson v Perrine (1882)</td>
<td>59</td>
</tr>
<tr>
<td>Tiley's Wills Trust [1967]</td>
<td>83</td>
</tr>
<tr>
<td>Torkington v Magee [1902]</td>
<td>10</td>
</tr>
<tr>
<td>Tovarischestvo Manufactur Luidvig-Rabenek [1944]</td>
<td>220</td>
</tr>
<tr>
<td>Trendtex Trading Corp. v Credit Suisse [1982]</td>
<td>20, 156, 162</td>
</tr>
<tr>
<td>Underwood v Stevens (1816)</td>
<td>238</td>
</tr>
<tr>
<td>United States of America v Dollfus Mieg</td>
<td>5, 14, 118</td>
</tr>
<tr>
<td>Van Gruten v Digby (1862)</td>
<td>177</td>
</tr>
<tr>
<td>Venables v Barring [1892]</td>
<td>33</td>
</tr>
<tr>
<td>Waltons Stores Interstate Ltd. v Maher (1988)</td>
<td>54</td>
</tr>
<tr>
<td>Webb v Herne Bay (1870)</td>
<td>33</td>
</tr>
<tr>
<td>Webb v Webb [1994]</td>
<td>201</td>
</tr>
<tr>
<td>Name of Case</td>
<td>Year</td>
</tr>
<tr>
<td>-------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Webb, Hale &amp; Co v Alexandria Water Co Ltd</td>
<td>1908</td>
</tr>
<tr>
<td>Westdeutsche Landesbank Girozentrale v Islington Borough Council [1994]</td>
<td></td>
</tr>
<tr>
<td>White v Jones [1995]</td>
<td></td>
</tr>
<tr>
<td>White v Lady Lincoln (1803)</td>
<td></td>
</tr>
<tr>
<td>Wilkins v. Hogg (1861)</td>
<td></td>
</tr>
<tr>
<td>Woodward v Rowe (1666)</td>
<td></td>
</tr>
<tr>
<td>Woodward v Woodward (1991)</td>
<td></td>
</tr>
<tr>
<td>Wboney v Pole (1890)</td>
<td></td>
</tr>
<tr>
<td>Zivnostenska Banka National Corporation v. Frankman [1950]</td>
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</tbody>
</table>
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Atiyah, The Rise and Fall of Freedom of Contract ................................... 95

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187, 208, 215

Benjamin, Custody; an English Law Analysis ............................................. 111, 122

Benjamin, Negotiability and Computerisation ............................................. 25

Bentham, Theory of Legislation, Principles of the Civil Code ....................... 7

Blackburn, Treatise on the Effect of the Contract of Sale ............................. 129

Blackstones, Commentaries ................................................................. 8, 10, 38, 63, 251

Boyles & Sykes, Gore Brown on Companies ............................................... 99, 104

Byles on Bills of Exchange ........................................................................ 40

Cheshire and Burn’s Modern Law of Real Property ...................................... 96

Cheshire and North’s Private International Law ......................................... 163, 164

Child, Discourse about Trade .................................................................... 73

Chitty on Contracts ................................................................................. 21, 143, 249

Contemporary Trends in Trust Law ............................................................ 232

Dias, Jurisprudence .................................................................................... 5, 7, 13-15, 117

Dicey and Morris, The Conflict of Laws ................................................. 150, 152, 155, 156, 158, 160-165, 168, 171,
172, 174, 180, 181, 193, 198, 204, 205, 251

Dubois, The English Business Company after the Bubble Act 1720 - 1800 . . . . . . 68, 95, 103
Encyclopedia of Banking Law ..................................... 33

Ewart, Negotiability and Estoppel ................................ 8, 31, 59, 76

Fifoot, The Development of the Law of Negotiable Instruments and the Law of Trusts 1, 31

Finn, The Fiduciary Principle, Equity, Fiduciaries and Trusts ............................... 228, 229

Fletcher, The Law of Insolvency ........................................ 217, 218

Ford and Lee, Principles of the Law of Trusts .................................. 138

Giuliano and Lagarde Report ........................................ 177, 178, 193

Glasson, International Trust Laws ........................................ 211

Goode Commercial law .................................................. 7, 14, 18, 29, 54, 73, 75, 138, 190

Goode, Legal Problems of Credit and Security .................................. 75

Goode, Ownership and Obligation in Commercial Transactions .......................... 123

Goode, Principles of Corporate Insolvency Law .................................. 24

Goode, The Nature and Transfer of Rights in Dematerialised and Immobilised Securities 4, 25, 26

Gray and Symes, Real Property and Real People, Principles of land Law .............. 6

Gray, C.L.J., Property in Thin Air ........................................ 5-7, 17, 21, 23

Group of Ten, Delivery v Payment in Securities Systems .................................. 4

Group of Thirty, Securities Clearance and Settlement ...................................... 4, 28

Guynn and Tahyar, The Importance of Choice of Law and Finality .................... 163

Guynn, I.B.A., Modernising Securities Ownership Transfer and Pledging Laws 14, 150,
<table>
<thead>
<tr>
<th>Author/Book</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Halsbury's Laws of England</td>
<td>76, 136</td>
</tr>
<tr>
<td>Hayton, <em>Developing the Law of Trusts for the Twenty-First Century</em> (1900)</td>
<td>244</td>
</tr>
<tr>
<td>Hayton, <em>International Recognition of Trusts</em></td>
<td>211</td>
</tr>
<tr>
<td>Hayton, <em>The Irreducible Core Content of Trusteeship</em></td>
<td>232, 235</td>
</tr>
<tr>
<td>Hayton, <em>Uncertainty of Subject-Matter of Trusts</em></td>
<td>139, 148</td>
</tr>
<tr>
<td>Hayton, <em>Underhill and Hayton, Law Relating to Trusts and Trustees</em></td>
<td>54, 55, 67, 82, 238, 239, 247</td>
</tr>
<tr>
<td>Holdsworth, <em>History of English Law</em></td>
<td>8, 22, 103</td>
</tr>
<tr>
<td>ISSA, <em>Symposium Report</em></td>
<td>124</td>
</tr>
<tr>
<td>Josling and Alexander, <em>Law of Clubs</em></td>
<td>64</td>
</tr>
<tr>
<td>Jowitt's Dictionary of English Law</td>
<td>5, 14, 104</td>
</tr>
<tr>
<td>Justinian's Institutes</td>
<td>251</td>
</tr>
<tr>
<td>Law Commission, <em>Fiduciary Duties and Regulatory Rules</em></td>
<td>227, 235, 243, 244, 247</td>
</tr>
<tr>
<td>Law Reform Committee, <em>The Powers and Duties of Trustees</em></td>
<td>237</td>
</tr>
<tr>
<td>London Business School, <em>Custodianship and the Protection of Client Property</em></td>
<td>208</td>
</tr>
<tr>
<td>Maitland, <em>Selected Essays</em></td>
<td>8, 22, 23, 69, 94, 250, 251</td>
</tr>
<tr>
<td>Maitland, <em>Trust and Corporation</em></td>
<td>8, 23, 68-70, 94, 250, 251</td>
</tr>
<tr>
<td>Mann, <em>The Legal Aspect of Money</em></td>
<td>7, 38</td>
</tr>
</tbody>
</table>

- xxvii -
Marius, Advice concerning Bills of Exchange ........................................... 27

Martin, Hanbury & Martin, Modern Equity .................................................. 65

Megarry & Wade, The Law of Real Property ............................................. 50, 136

Milman, The Courts and the Companies Acts: the Judicial Contribution to Company Law 69

Milnes Holden The History of Negotiable Instruments in English Law ........ 27, 31, 73, 146

Mooney, Beyond Negotiability ................................................................. 4, 33, 185, 251

Morgan Guaranty, Cross-Border Clearance, Settlement and Custody: Beyond the G30 Recommendations ................................................................. 4, 185

Morris and Barton Leach, The Rule Against Perpetuities ........................................... 65

Moshinsky The Assignment of Debts in the Conflict of Laws ................ 53, 163, 172, 193, 194

Osborne's Concise Law Dictionary .............................................................. 50

Palmer, Bailment ...................................................................................... 15, 115-117, 121, 230

Palmer, Liability of Bankers as Custodians of Client Property .................... 114

Palmer's Company Law ............................................................................. 94

Pollock and Wright, An Essay on Possession in the Common Law ............... 5, 13, 43, 114

Prime, International Bonds and Certificates of Deposit ............................... 26, 29, 32, 61, 72, 151

Quah, Cross Border Collateralisation Made Easy ........................................ 189

R.R. Formoy, The Historical Foundations of Modern Company Law ................. 69, 70, 94, 103

Ryan, Taking Security Over Investment Portfolios held in Global Custody .... 124, 126

Shartel, Meaning of Possession .................................................................... 14
<table>
<thead>
<tr>
<th>Author/Editor</th>
<th>Title/Work</th>
<th>Page(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simpson</td>
<td>A History of the Land Law</td>
<td>10</td>
</tr>
<tr>
<td>Smart</td>
<td>Cross-Border Insolvency</td>
<td>221, 226</td>
</tr>
<tr>
<td>Snell</td>
<td>Principles of Equity</td>
<td>75, 116</td>
</tr>
<tr>
<td>Stroud</td>
<td>Judicial Dictionary of Words and Phrases</td>
<td>40</td>
</tr>
<tr>
<td>Tennekoon</td>
<td>The Law and Regulation of International Finance</td>
<td>30, 32, 73</td>
</tr>
<tr>
<td>Todd</td>
<td>Textbook on Trusts</td>
<td>64</td>
</tr>
<tr>
<td>Trust Law Commission</td>
<td>Collective Delegation of Trustees' Powers and Duties</td>
<td>238, 239</td>
</tr>
<tr>
<td>Warburton</td>
<td>Unincorporated Associations: Law and Practice</td>
<td>64, 67</td>
</tr>
<tr>
<td>Waters</td>
<td>The Law of Trusts in Canada</td>
<td>205</td>
</tr>
<tr>
<td>Winfield</td>
<td>Jolowicz on Tort</td>
<td>248</td>
</tr>
<tr>
<td>Wood</td>
<td>Comparative law of Security and Guarantees</td>
<td>187, 190, 205</td>
</tr>
<tr>
<td>Wood</td>
<td>Law and Practice of International Finance</td>
<td>32</td>
</tr>
<tr>
<td>Wood</td>
<td>Principles of International Insolvency</td>
<td>210, 213, 221</td>
</tr>
</tbody>
</table>
Chapter 1. Introduction

"Knowledge of these things would be much easier learnt in the City than in the courts." ¹

1. The Global Network

Global custody is a service whereby a single custodian assumes responsibility for the safekeeping of its client's portfolio of international securities and cash. In respect of overseas assets, it may perform its obligations either directly through overseas branches, or through sub-custodians.³ The global custodian, its overseas branches and sub-custodians may in turn use nominees, clearing and settlement systems and common depositaries. The client's contractual relationship and dealings are only with the custodian, who keeps the global network behind the scenes.

2. The Service

The traditional custody product comprises the core services of safekeeping and settlement.⁴ Customarily associated with this core product are basic portfolio administration⁵ together with foreign exchange services.⁶ These core and associated


² "A global custodian provides its customers with access to settlement and custody services in multiple markets through a single gateway by integrating services performed by a network of sub-custodians, including the global custodian's own local branches and other local agents. The primary advantage to institutional investors of using a global custodian rather than a network of local custodians appears to be lower costs made possible by the global custodian's realisation of economies of scale and scope. The provision of custody and settlement services requires significant investments in information technology, communications systems and local agent networks. A global custodian, through economies of scale and scope, is able to spread its fixed costs over more transactions and to offer a variety of reporting, information, accounting and credit services to the investor at lower cost than if these services were purchased separately from a variety of service providers and local agents. By using a global custodian, an investor also avoids the burdens imposed by the need to maintain multiple communications links, conform to multiple formats for inputting settlement instructions, and receive and interpret reports from local agents in each local market in which it trades." Bank for International Settlements, Cross-Border Securities Settlements, March 1995, p. 15.

³ "Sub-custodians play a large role in cross-border settlements. Participation in domestic settlement systems is typically restricted to local entities. In other cases, the custodian may be unwilling to take on the risks or obligations of direct participation." Bank for International Settlements, Cross-Border Securities Settlements, March 1995, p. 15

⁴ (i.e. the receipt and delivery of securities and cash to settle client trades.)

⁵ (i.e. income and dividend collection and withholding tax reclamation, proxy voting, handling corporate actions and trade portfolio reporting.)
functions are increasingly supplemented by value-added services, whereby the custodian cross-sells front office financial products to its custody clients. 7

3. The Participants

Global custody was first developed in the United States, in response to the regulatory needs of pension funds, including the obligation to have an independent custodian. The service was developed in London in the 1980s, and today many of the leading global custodians operating in London are the UK branches of US banks. Custodians have traditionally been banks. Certainly, non-bank entities play a role. For example some fund managers and brokers provide custody "in-house" for their clients, and clearing systems with international depository networks are upgrading their services to approach the role of the global custodian. Global custody requires an enormous investment in electronic and other systems. It is in some respects a distressed industry, with the over-provision of custody services pushing fees downward, while the measure of systemic risk associated with cross-border safekeeping and settlement is a source of increasing concern. Recent years have seen some significant withdrawals from the industry, while a number of mergers and business transfers has further reduced the number of global custodians.

The major clients of global custody have always been private pension funds. For demographic reasons, private pension funds will continue to grow in the decades ahead. With an increasing trend towards cross border investment (together with continuing settlement inefficiencies in local markets) the need for global custody will remain. Non-pension managed funds also constitute a growth industry requiring custodial services. Clients of the global custodian also include other entities having large international securities portfolios, such as insurance companies, and some building societies, corporate treasury operations and central banks.

(e. g. converting sale proceeds from one currency into another in order to finance a purchase).

These include cash management, cash lending, stocklending, repos (repurchase agreements) and derivatives. With the master trust product, custodians offer enhanced administrative services such as consolidated reporting, valuation and portfolio analysis including performance measurement. Some custodians offer index tracking and even investment recommendations.

The profits derived by custodians from value-added services are so great that certain custodians provide the core functions for free; it has even been predicted that (in view of this profitability and in response to commercial pressures from fund managers) custodians will pay their clients to place their assets with them.
4. Uncertainty

At the date of writing, there is a lack of consensus as to the correct legal analysis of global custody under English law. The principal reason for this is that English law has failed to keep pace with modern global custodial practice. Many of the relevant cases date from an era when banker's custody meant promissory notes in strong boxes. The ideas judicially developed in those cases (relating to the ownership and safekeeping of securities) rested on the assumption that documentation, and therefore physical possession, were involved. With trends towards dematerialisation in the securities markets, securities are increasingly intangible in the hands of the global custodian. In the absence of legislative clarification, therefore, the position has become uncertain. The traditional characterisations of bearer debt securities as negotiable, and of the custodian as a bailee, are no longer appropriate where no paper is involved. If the legal status of the portfolio and of the custodian is unclear, the rights and liabilities of the custodian and its client cannot be established with certainty. Risk analysis and risk management is frustrated.

Another source of legal uncertainty is the international aspect of global custody. This raises complex issues of private international law, on which there is a dearth of directly relevant case law. The following analysis of global custody under English domestic and private international law is an attempt to reduce this uncertainty.

5. Analytic Context

This work is submitted in the context of a body of analysis relating directly and indirectly to custody. The SIB custody review is nearing completion and Treasury proposals for the regulation of custody have been published. International settlement risk has been.

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8 See chapter 3 for a full discussion of the computerisation of securities.
9 See chapter 3 section B
10 See chapter 4.
11 See chapters 6 and 7.
12 The context of this is a wider uncertainty affecting many aspects of financial practice. Colin Bamford of the Financial Law Panel comments, "At the end of the 1980s, and into the beginning of the 1990s, there was a growing feeling in the financial markets that the pace of development of concepts and products was much greater than that of development in the legal system." Editorial, (1995) 9 J.I.B.F.L.
addressed in a number of reports\textsuperscript{13} while the role of the clearing systems has been analysed in recent articles.\textsuperscript{14}

6. Scope

In view of the applicable word limit, a number of completed chapters have been omitted from this work.\textsuperscript{15} Tax and derivatives are dealt with only incidentally. Both English domestic and private international law are considered. It is assumed throughout that the global custodian operates in London and that English law governs the global custody contract.


\textsuperscript{15} These are: stocklending and repos, depositary receipts, principles of settlement, the CGO, the CMO, CREST and regulation. They will be published in a forthcoming book based on this work.
Chapter 2. English domestic law principles

This chapter will discuss the legal principles that have historically determined proprietary and other rights in custody assets under English domestic law. The following chapters will consider the impact on these traditional principles of the computerisation of securities.

1. Assets, Possession and Property

This section will begin with the respective differences between assets, possession and property.

a. Assets

A person's assets are those of its resources which are legally available for the payment of its debts (for example its money but not its body).

b. Possession

Possession is the control of an asset. When physical control of an asset is combined with awareness of the situation by the controller, possession arises. I possess the pen with which I write this.

---

16 The discussion in this chapter of possession and property is necessarily brief, and does not address the complexities surrounding these terms. "The essence of 'property' is indeed elusive.", Kevin Gray, C.L.J., Property in Thin Air, (1991) 50, 252 at 292; "... in truth, English law has never worked out a completely logical and exhaustive definition of 'possession'", per Viscount Jowitt, United States of America v Dollfus Mieg et Cie S.A., [1952] AC 582 at 605.

17 The word derives from the Latin assatis, meaning sufficiency. The old French legal phrase aver asetz meant to have sufficient goods and effects to meet claims such as debts and legacies.


19 See the Merchant of Venice, Shakespeare, Act 4 Scene 1 line 99 - 101.

20 I do not possess drugs dropped into my handbag without my knowledge: Lockyer v Gibb [1966] 1 All ER 653 at 655 per Lord Parker CJ.

21 In Roman law, from which our concept of possession derives, "...the facts needed to acquire possession were physical control, 'corpus possessionis', and an awareness of the situation, 'animus...'". R.M. Dias, Jurisprudence 5ed, Butterworths, London 1985 at 274. These concepts equate to "possession in fact" and "possession in law": see Pollock and Wright, An Essay on Possession in the Common Law, 1888, Oxford, Clarendon Press, p. 11.
c. Property

Property is ownership of an asset. It is a bundle of rights\(^\text{22}\) including the right to possession\(^\text{23}\). This pen in my possession is the property of my employers. I have it, but it is not mine. \(^\text{24}\)

d. Legal Relationships

We speak loosely of a person's possessions and property as if they were assets. More accurately, the words "possession" and "property" refer to legal relationships between persons in respect of assets. If an asset is a thing (such as this pen) and possession is a relationship between a person and a thing (such as my control of this pen), property is a legal relationship between persons in respect of things\(^\text{25}\) (the right of my employer to say to me, "Give it back"). However, it is often in practice convenient to think of property in the same terms as possession, as a relationship between persons and things. Where ownership and possession of an asset are with two different persons, the legal relationship between those persons is usually described as a bailment.\(^\text{26}\)

e. Property is relative

In practice property and possession usually coincide in the same person\(^\text{27}\). The two terms are closely related and were once used interchangeably\(^\text{28}\). More recently the terms have become distinct, but linked in that each one raises the

\(^{22}\) See, Kevin Gray, Property in Thin Air op. cit., at 259.

\(^{23}\) "An owner is prima facie entitled to possession ... ". Pollock op. cit., p. 25.

\(^{24}\) For a discussion of the distinction between property and possession in the context of the law of theft, see R v Gomez [1993] 1 All ER 1 per Lord Lowry at 24.

\(^{25}\) "Thus, for the lawyer, the law of property is concerned with the network of legal relationships prevailing between individuals in respect of things." K.J. Gray and P.D. Symes, Real Property and Real People, Principles of Land Law, London, Butterworths, 1981, at 8.

\(^{26}\) See the definition of bailment per Holt C.J in Cogs v Bernard (1703) 1 All ER 1 at 5, 6.

\(^{27}\) "It is also said that possession is in a normal state of things the outward sign of ownership or title....", Pollock op. cit., p. 4

\(^{28}\) "... but it is necessary to observe that there are numerous cases in the Year-book and old writers in which the word "property" is used to signify possession, and property is attributed alike to the owner, the bailee, and the trespasser ...." Wright, op. cit., p. 122.
preumption of the other. Possession is the root of title or property. In the case of assets in current circulation, such as cash and negotiable instruments, ownership follows possession. There can be no asset without property in it and no proprietary right that does not attach to an asset.

In spite of the closeness of the two terms, there are important differences between them. While possession is, finally, based on questions of fact, ownership is a question of law. As a corollary of this, possession is absolute but property is relative. Different persons may have property in the same asset. Proprietary rights may be future, conditional and partial. They


30. Ibid p. 22

31. "...chattels of such kind [coin or banknotes] form part of what the law recognizes as currency and treats as passing from hand to hand in point, not merely of possession, but of property." Lord Haldane L.C., Sinclair v Brosgaham, (1914) 1 All ER 623, 633, quoted in F.A. Mann, The Legal Aspect of Money, 5ed, Clarendon Press, Oxford, 1992, p. 11.

32. In the case of bills of exchange, a class of negotiable instrument, "The property and the possession are inseparable." per Eyre C.J., Collins v Martin (1797) 1B&P 648 at 651.

33. Assets are always owned (See R.M. Goode Commercial law, 1985, Penguin, London p.55, note 41). However there are resources which are not assets and incapable of property. Indeed "...the vast majority of the world's human and economic resources still stand outside the threshold of property...", Kevin Gray, Property in Thin Air, op. cit., p. 256. Examples of non-proprietary resources include the high seas, the upper stratum of airspace, light, air, fire, water, wild animals and language.

34. A purported proprietary right that does not attach to an asset is a mere personal right: see Mac-Jordan Construction Ltd v Brookmount Erostin Ltd (in receivership) [1992] BCLC 350, CA.

35. See the discussion in section 2(a) below.

36. "We shall see that there is no such thing as natural property, and that it is entirely the work of law.... There is no image, no painting, no visible trait, which can express the relation that constitutes property. It is not material, it is metaphysical; it is a mere conception of the mind.... Property and law are born together, and die together. Before laws were made there was no property; take away laws, and property ceases." Bentham, Theory of Legislation, Principles of the Civil Code, Part I pp. 111 - 113, London, Routledge and Kegan Paul Ltd., 1931.

37. "Possession is single and exclusive. As the Romans said, 'plures eandem rem in solidem possidere non possunt.' This follows from the fact of possession being taken as the basis of a legal right. Physical possession is exclusive, or it is nothing. If two men have laid hands on the same horse or the same sheep, each meaning to use it for his own purposes and exclude the other, there is not any de facto possession until one of them has gotten the mastery" (Pollock, p.21). (However, possession may be joint, as where two persons cohabit a home, and may be concurrent for different purposes: see Dias, Jurisprudence at 277.)

38. "Propertiness is represented by a continuum along which varying kinds of 'property' status may shade finely into each other." Kevin Gray, Property in Thin Air, op. cit., at 296.
may subsist as against some persons but not others. Any right of property may be relative to competing proprietary rights in the same asset.  

f. Possession and Property as Remedies

Without property, one could not assert rights to assets in the hands of others (and "custody" would be a meaningless term). Property is the courts' recognition of the rights of the owner out of possession. Property is (in origin) a remedy which evolved from judicial decisions, and it is inseparable from the old court procedures through which they were reached.  

39 Equitable property is enforceable against all but the bona fide purchaser for value of the legal estate without notice of the equitable property.

40 Indeed, the idea of property is only necessary where there are competing claims to assets; without such competing claims, the possession of assets is sufficient for their enjoyment. See section f. below.


43 The process by which choses in action evolved from personal rights into proprietary rights was the development of proprietary remedies. "But, as the common law developed, it soon became apparent that certain actions in tort were in substance actions to recover property; and we have seen that, by means of developments both in the actions of detinue and trespass, the proprietary rights of the owner out of possession were coming to be better protected... We might therefore have expected that the rights of the owner out of possession would come to be recognised as something more than a mere personal chose in action; and that they would develop into assignable rights of property." W. S. Holdsworth, A History of English Law, Menthuen & Co, Ltd, London Volume VII, Chapter 11, Section 3, p. 52. The remedial origin of choses in action is also clear from the following passage in Blackstone: "At present we have only to remark, that upon all contracts or promises, either express or implied, and the infinite variety of cases into which they are and may be spun out, the law gives an action of some sort or other to the party injured in case of non-performance; to compel the wrongdoer to do justice to the party with whom he has contracted, and, on failure of performing the identical thing he engaged to do, to render a satisfaction equivalent to the damage sustained. But while the thing, or it's equivalent, remains in suspense, and the injured party has only the right and not the occupation, it is called a chose in action, being a thing rather in potentia than in esse..." Commentaries, Book II, at 397.

44 This is clear in the distinction between real and personal property: real property is, functionally, property for which real (possessory) actions were available in the courts, and personal property was, until recently, property for which such actions were not available: "...in the Middle Age, and indeed until 1845, the claimant of a movable could only obtain a judgement which gave his adversary a choice between giving up that thing and paying its value. And so, said we, there is no actio realis for a horse or a book.", Maitland, Selected Essays, Cambridge University Press, 1936, Trust and Corporation, p. 146.

The procedural nature of the category of property into which most custody assets fall, namely choses in action, is particularly clear. Choses in action, discussed in section 4.b below, were originally mere rights of action. Holdsworth comments, in his History of English Law: "It is obvious that the number and variety of these rights, and the manner in which they are developed by the law, must to a large extent depend on the law of procedure. The law of actions determines necessarily the conditions under which a right is asserted by action" Holdsworth, op cit, p. 519. Equally, the purely procedural status of a certain category of choses in action, namely negotiable instruments, is made clear in the paper by J.S. Ewart, Negotiability and Estoppel (1900) 15 LQR (1900) 135.
does not inhere in assets, or even exist in any abstract sense. It arises only in order to resolve disputes.\textsuperscript{45} Property may differ from obligation in that it is not essentially personal; like obligation, however, it is essentially judicial.\textsuperscript{46} Two consequences flow from this. Firstly, these legal concepts cannot develop ahead of case law. They consist of the case law, and, where events run ahead, the legal ideas are left behind. As an example of this conservatism, it will be argued (in section 2, and in chapters 3 and 4) that the computerisation of the securities markets have taken them beyond the scope of the concept of possession. Secondly, the value of seeking to extrapolate abstract principles from case law is limited. If one tries to understand property in abstract terms as a notional duplicate of the asset to which it relates, it quickly becomes anomalous, apparently being diluted, extinguished and arising de novo depending upon the circumstances.\textsuperscript{47} The historic function of property is as procedure for resolving situations in which competing claims to assets have arisen. It is only possible and only necessary to understand property in the context of those situations\textsuperscript{48}. The need for a concrete and indeed pragmatic approach is most clear in the cross border proprietary aspects of global custody, as discuss in chapter 7.

\textsuperscript{45} See David Hayton, \textit{Hayton and Marshall, Cases and Commentary on the Law of Trusts}, 9ed, London, Sweet & Maxwell, 1991, at p12: "To conclude, in order to understand the working operation of a trust it is better to regard the interest of a beneficiary as an \textit{in personam} right to compel the trustees to perform the trust, \textit{i.e.} as an equitable chose in action situated where the trustees reside and administer the trust. However, where things have gone wrong and trust property finds its way wrongly into the hands of a third party (other than equity's darling) then it is appropriate to regard the interest of a beneficiary, as a result of his equitable tracing rights, as an equitable \textit{in rem} right."

\textsuperscript{46} Millet J commented during a talk given at Kings College, London in March 1995, "English law has always viewed rights in terms of remedies." (1995) 6 KCLJ 1, 18

\textsuperscript{47} For example see the exception to the rule, \textit{nemo dat quod non habet}, and the doctrines of title by estoppel and overreaching (see chapter 3 sections [B.7] and C.2.e] below.

\textsuperscript{48} This is also true of possession. "The melancholy record of theorising on this topic [of possession] serves as a warning against an \textit{a priori} approach. The Jurists, who theories have been discussed, proceed on the assumption that words always have to refer to some referent and are concerned to discover what this `thing' is: the law, on the other hand, has proceeded functionally." Dias, at 289.
English law distinguishes between real and personal property. Real property relates to freehold land and personal property relates to other assets.

There are two types of personal property, choses in possession and choses in action. A chose in possession is a right of property in a tangible asset which can be enforced by taking physical possession of the asset. "'Chose in Action' is a legal expression used to describe all personal rights of property, which can only be claimed by action and not by taking physical possession." These are property rights in intangibles such as debts.

Another necessary distinction is that between legal and equitable property. Modern English law has several branches, stemming from the different courts that have been sources of judicial precedent. The proprietary remedies granted by the (originally feudal) King's court as part of the common law give us the concept of legal (or technical) ownership. Those granted by the less formal Chancellor's court as part of the law of equity give us the concept of equitable (or beneficial) ownership. Legal ownership has been compared to the shell of a nut and beneficial ownership to its kernel. The legal owner of an asset must be involved in any dealing with third parties. Thus, the legal owner of shares receives the dividends from the issuing company and must be involved in any transfer of the shares. The beneficial owner of assets is entitled to enjoy them. Thus, the legal owner of shares must account for dividends and proceeds of sale to the beneficial owner. Where the legal and beneficial ownership of an asset

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49 The law of real property governs freehold interests in land and the law of chattels real governs leasehold interests. (In the early medieval era, leasehold interests differed from freehold interests in that the personal relationships that they reflected were economic and not feudal. The leaseholder did not owe homage to the freeholder. For this reason, the medieval courts long refused to protect leasehold interests by the proprietary remedies conferred by the feudal common law, and they were not recoverable by real actions, but treated as merely chattels protected by contractual remedies. However in the more commercial climate of the late medieval era a dispossessed leaseholder became entitled to recover his land. "The eventual solution was to call his interest a 'chattel real', so recognising the fact that it partook both of the nature of real property and of chattels." Simpson, A History of the Land Law, 2ed, Clarendon Press, Oxford, 1986, at 76.) Blackstone describes chattels real as "...that kind of property being of a mongrel amphibious nature, originally endowed with one only of the characteristics of each species of things; the immobility of things real, and the precarious duration of things personal." Commentaries on the Laws of England, Volume II Of the Rights of Things (1766), at 387,388.

50 "All personal things are either in possession or action. The law knows no tertium quid between the two". Colonial Bank v Whinne (1885) 30 Ch D at 285 per Fry L J, dissenting judgment upheld in House of Lords (1886) All ER Rep 468.

51 Per Channell J, Torkington v Magee [1902] All ER 991
are held by different persons, the relationship between the legal and beneficial owner is generally described as a trust.  

h. **Summary: Personal Assets**

Assets (or at least tangible assets) are capable of possession as well as of property. Where physical possession and property are with two different people, a bailment arises. A right of property in a tangible asset is called a chose in possession and a right of property in an intangible asset is called a chose in action. Property may be legal or equitable. Where legal and equitable ownership are with two different persons, a trust arises.

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52 For a judicial discussion of the differences between trust and agency, see *Baker v Archer-Shee* (H.L.) [1927] A.C.844, per Viscount Sumner at 850.

53 The bailor retains a form of legal possession.
In the modern securities markets, as a result of the widespread use of nominees and of trends towards dematerialisation and the pooling of securities (as chapter 3 below will

As a matter of common law there is no such thing as an equitable chose in possession. "Uses, trusts and other equitable interests in property, though regarded by equity as conferring proprietary rights analogous to the rights recognised by law in hereditaments or in chattels, were regarded by the common law as being merely choses in action" Holdsworth, op. cit., at 516. However, the law of equity contemplates equitable choses in possession: see Pearson v IRC [1980] 2 All ER (HL) 479, in which a life interest in intangible property (shares) conferring a present right to present enjoyment was treated as an interest in possession.

Equity follows the law, and an equitable (or informal) assignment of a legal chose in action will confer on the assignee an equitable chose in action.

The interest of a beneficiary under an unadministered estate is an equitable chose in action: Commissioner for Stamp Duty v Livingston [1965] A.C. 694, and Marshall v Kerr [1994] 1 AC 148 An interest under a trust is an equitable chose in action against the trustee, provided it is unascertained. However, if it amounts to a present right of present enjoyment, then it is treated as a chose in possession i.e. an interest in the trust property (and so income is taxable when received by the trustee and not only when received by the beneficiary): see Baker v Archer-Shee [1927] A.C. 844 and Pearson and others v Inland Revenue Commissioners. See also Commissioner of Stamp Duty (Queensland) v Livingston [1965] A.C. 604 and Cholmondeley v IRC (1986) STC 384.

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<p>| Assets |</p>
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<tr>
<th>Tangible</th>
<th>Intangible</th>
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<tr>
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<td>bailment</td>
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<td>legal ownership</td>
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55 Equity follows the law, and an equitable (or informal) assignment of a legal chose in action will confer on the assignee an equitable chose in action.
argue) the rights of most investors in securities are (as a matter of English law) equitable choses in action. 56

2. Possession of Intangibles

Equitable choses in action are intangible. Intangible property is incapable of physical possession. "Possession is a deceptively simple concept. It denotes a physical control or custody of a thing plus knowledge that you have it in your custody or control." 57 However Dias comments, "...the term [possession] is not confined to physical control." 58 Might it therefore be argued that intangibles are capable of possession?

a. legal possession

The context in which Dias made this comment related to the distinction between physical and legal possession. Legal possession has been described as the right to possess. 59 It is true that the law recognises both physical (or actual) and legal (or civil) possession. 60 However, the ultimate basis of possession is always fact rather than law because "the existence of the de facto relation of control or apparent dominion [is] required as the foundation of the alleged right." 61

b. constructive possession

The concept of legal possession, then, does not help in showing that intangibles are capable of possession. The concept of constructive possession seems more promising at first sight. Possession in fact need not involve direct physical

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56 Equitable, because arising under a trust, and chose in action because intangible. Here, these interests are called choses in action under the common law which does not recognise equitable choses in possession. This seems helpful in order to place such interests in the context of the common law history of choses in action, discussed in section 4 b below.

57 R v Boyesen [1982] 2 All ER 161 at 163, HL, per Lord Scarman. See also Marsh v Kulchar [1952] 1 DLR 593 at 595, per Kellock J: "The word ‘possession’ in English law is, as has often been pointed out, a most ambiguous word. As most often used, however, it imparts actual physical possession...".

58 Dias, Jurisprudence, at 277

59 "When the fact of control is coupled with a legal claim and right to exercise it in one's own name against the world at large, we have possession in law as well as in fact." Pollock, Possession in the Common Law, at 16.

60 and that there is no clear answer to the question, "Is Possession a matter of fact or a right?" Pollock, op. cit., p 10

61 Pollock op. cit., p. 10.
possession, for the law recognises symbolic, as opposed to actual (or physical) possession. However, as with legal possession, the concept of constructive possession is derived from the concept of actual possession (i.e. physical possession) and therefore cannot apply to intangibles.

62 "Possession in the legal sense may exist without physical possession. It is possession attributed in law to a person and describes his or her legal relation to a thing with respect to other persons. It has sometimes been called constructive possession." R v Martin [1948] OR 963 at 966, per Laidlaw JA. "Handing over a key is a symbolic act, which at common law carried with it possession of that to which the key is the means of access." Holt v Dawson [1939] 3 All ER 635 at 637, per Scott LJ.

63 "A person has actual possession (de facto possession, possession in fact) of a thing when he exercises physical control over it... A person has constructive possession... when someone representing him has actual possession of the thing." Jowitt's Dictionary of English Law, under "Possession".

64 Relevant case law is mainly concerned with keys to rooms and boxes in which physical property is contained: "Constructive possession, properly speaking, exists in relation to the deeds in a box of which one has been given the key": USA v Dollfus Mieg (1952) A.C.582, Counsel for the respondent, at 589. Woodward v Woodward (1991) 21 Fam Law 470 relates to the keys of a car. See also cases referred to by Dias, Jurisprudence, at 278, and Sen v Headley [1991] 2 All ER 636. Another example of constructive possession arises in the context of taking security over imported goods. "The most common form of security is a pledge of the bill of lading and other shipping documents. This is treated in law as equivalent to a pledge of the goods themselves and is thus effective to give the bank a legal possessory interest in the goods." R.M. Goode, Commercial Law, 2 ed, 1995, London Penguin p. 1027.

65 See Shartel, Meaning of Possession (1932) 16 Minnesota Law Review 611 at 612, quoted in Dias at 285: "I want to make the point that there are many meaning of the word 'possession'; that possession can only be usefully defined with reference to the purpose in hand; and that possession may have one meaning in one connection and another meaning in another." Clearly, possession for the purposes of the criminal law relating to drugs or offensive weapons, is not the same as possession in the context of custody. This is partly because the meaning of possession in each legal context in which it arises was largely shaped by policy considerations peculiar to that context. See Dias, Jurisprudence, at p. 289: "...the nature of possession came to be shaped by the need to give remedies...". and at 280, 281: "Turning to the law of tort, the axiom is that possession is the basis of trespass, and the policy of this branch of law is to compensate the party whose interests have been affected... The doctrine of 'trespass by relation' is another example of the artificial manipulation of the concept of possession so as to provide a remedy in trespass to one deserving compensation."
relevant context, i.e. the possession of intangible personal property for the purposes of custody or safekeeping. There are many examples of possession of intangibles in other contexts, but they do not assist here.

Roman law gave the concept (described by Dias as "uncouth") of the possession of a right. However, there is no judicial authority for the extension of this Roman concept into English common law (as opposed to equity: see below). Salmond argued that intangibles are capable of "incorporeal possession". Unfortunately, he does not give any judicial authority for the recognition by English common law of incorporeal possession; his argument is based on civil law. Nowhere is there authority that, in English common law, intangible personal property is capable of possession in the context of safekeeping.

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66 Land law provides the doctrine of seisin. Certain forms of real (or land related) property may be said to be intangible, and known as incorporeal hereditaments. Examples are reversionary, remainder and advowson. Seisin is the doctrine of possession of these things. However, it would be a quantum leap to extend the feudal doctrine of seisin to the late 20th century securities markets. Another example is the concept of possession of money for the purposes of the Debtors Act 1869 (which, when paid into a bank account, is in the nature of a debt and therefore intangible): see Middleton v Chichester, [1871] 6 Ch. 152, and Crowther v Elgood, [1882] 34 Ch. D 691. See also Chief Constable of Kent v V and Another, Court of Appeal (Civil Division), [1982] 3 All ER 36.

67 Jurisprudence at 274

68 possessio juris: see Dias, Jurisprudence, at 274.

69 N.E. Palmer discusses these questions in his book, Bailment, 2ed, London, Sweet & Maxwell, 1991. There have been cases in which a plaintiff suing a bailee for conversion has recovered the value of rights represented by documents, or of rights of action represented by documents. In Building & Civil Engineering Holidays Schemes Management Ltd v Post Office [1969] 1 QB 247 there was a bailment of holiday credit stamps. In an action for conversion, the bailor was held to be entitled to recover not only the value of the stamps as pieces of paper but a sum represented by their actual value to the bailor. In Borden Chemical Co (Canada) Ltd v J.G. Beukers Ltd [1973] 29 D.L.R. (3d) 337 there was a claim for conversion of a customer list. The bailee had used the list to deal with the customers on its own account. The bailor claimed for the conversion of its "entire distribution system". It was held that the conversion was only of the customer list, but the award included damages for the detention of the converted property. However these cases cannot be taken as authority that there can be possession (because bailment and conversion) of a right. Rather, the principle established by these cases is that, provided there is a piece of tangible property to form the subject matter of a bailment, damages awarded for conversion of that property by a bailee may include some element of consequential damages.


71 "Corporeal possession involves, as we have seen, the continuing exercise of exclusive control over a material object. Incorporeal possession is the continuing exercise of a claim to anything else." Jurisprudence, at 58.

72 Roman, French, Italian and German law.
A major part of the difficulty in extending the doctrine of possession to intangibles is the lack of procedural precedent. The modern common law of possession evolved from the legal procedures developed from the disputes relating to land and goods. There was no procedure for, and hence there is no clear concept of, possessory remedies in relation to personal intangibles such as securities.

d. **common law**

In the context of custody the prudent approach is therefore to assume, given the absence of judicial authority to the contrary, that intangibles are incapable of possession at common law. Therefore the handing over to a third party of control of intangible personal property for the purposes of safekeeping (or security), cannot give rise to bailment (or pledge), as these are common law concepts based on possession.

e. **equity**

The courts of equity have always been more comfortable with intangibles than the common law courts, because an interest under a trust is intangible. In equity (if not at law) such an interest is capable of possession. Intangible property which is capable of possession in equity, or an equitable chose in possession, is (very broadly speaking) a present right to sue in equity, or a present right of present enjoyment. If the handing over to a third party of control of intangible personal property for the purposes of safekeeping or

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73 Indeed in the last century it was unclear whether even materialised securities were capable of possession. "...at the beginning of the nineteenth century, it was very doubtful how, if at all, a husband could reduce into possession stock belonging to his wife." Holdsworth, op. cit., p. 542

74 "Under the old procedure an actual possessor who had been dispossessed might sue either in trespass for the wrong to his possessions, or in a form of action founded on right to possess (ejectment for land, trover for goods)." (Pollock, op. cit., p.91).

75 i.e. not relating to land.

76 In *Pearson v IRC* [1980] 2 All ER (HL) 479 an interest in possession in settled property was judicially defined as "...a present right of present enjoyment" (per Viscount Dilhorne, at 485). (An interest in possession in trust assets is equated to an *in rem* right in such assets, as opposed to a mere *in personam* right against the trustee, and the difference is crucial for income tax and inheritance tax purposes: see David Hayton, *Hayton and Marshall, Cases and Commentary on the Law of Trusts*, 9ed, London, Sweet & Maxwell, 1991, at p. 12 and Hayton, *The Law of Trusts*, 2 ed, 1993, London, Sweet & Maxwell, pp. 161-163)
security cannot give rise to the common law possessory concepts of bailment or pledge, it can give rise to their equitable equivalents, trust and charge.

f. conclusions

Intangibles cannot be possessed at law but can be possessed in equity. Therefore where control of assets (such as securities) are handed over to third parties, by way of safekeeping or security, the dematerialisation of such assets has the effect of diverting the custodial or security relationship from common law to equity: no longer bailment, but trust; no longer pledge, but charge. This is legally significant because the shift from bailment to trust raises questions of higher fiduciary duty,\textsuperscript{77} and the shift from bailment to charge raises questions of registration.\textsuperscript{78}

3. Proprietary and Personal Rights

a. Generally

The preceding section discussed proprietary rights in assets. There is another class of rights in respect of assets: that of personal rights. Since medieval times, English law has treated the difference between the two classes as fundamental.\textsuperscript{79}

If A buys 10 cases of claret from B, who has more than 10 cases and who earmarks 10 specific cases for A in his cellar, A acquires 10 cases of claret (a proprietary right). If, however, B does not identify the 10 cases, then provided A has not yet paid for the wine\textsuperscript{80} A may merely acquires a contractual right against B for delivery of 10 cases of claret (a personal right).

\textsuperscript{77} Chapter 4 will examine these issues in detail.

\textsuperscript{78} While a pledge is not registrable, a charge may be. It is therefore important to ensure that a purported pledge over intangible securities is not void as an unregistered charge.

\textsuperscript{79} "In conventional legal doctrine much energy is devoted to patrolling the frontier between property and contract.". Kevin Gray, Property in Thin Air, at p. 302.

\textsuperscript{80} Sale of Goods Act 1979 Section 20A
The difference for A is clear on B's insolvency. A proprietary right attaches to the asset and is unaffected by B's insolvency. However a personal right does not make A the owner of 10 cases but merely the unsecured creditor of an insolvent, and therefore A's claim will be subject to delay and abatement depending on the outcome of the liquidation.

A personal right is only as good as one's ability successfully to sue the obligor; this may be defeated by the obligor's insolvency. For this reason, legal commentators draw a fundamental distinction between personal and proprietary rights (or between obligations and ownership).

The distinction is fundamental in the context of custody. If the custody client's rights are merely personal against the custodian, it takes the custodian's credit risk. If its rights are proprietary, it does not. However, we must tread with light feet in making the distinction here, because (at first sight) the custody assets themselves are personal (and not proprietary) in nature.

The concepts of property and obligation are both dynamic, and have changed from time to time. Both concern the remedies made available by the courts in the context of disputes, and throughout legal history both have evolved as the approach of the courts, and the remedies made available by them, have changed. Indeed, the development of certain branches of the law might be summarily described the evolution of remedies (and therefore of rights) from the personal into the proprietary. Two leading examples of this are the law of equity, and the law of choses in action. As already indicated, chapter 3 below

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81 See Re Goldcorp Exchange Ltd (in receivership) [1994] 2 All ER 806 and chapter 5 below.

82 Provided the transaction is not at an undervalue or otherwise voidable under the Insolvency Act 1986.

83 Another adverse consequence of rights in respect of an asset being merely personal and not proprietary, is that if the holder of those rights suffers loss because of loss of or damage to the assets due to another's want of care, it cannot sue that other in negligence: see Leigh and Sillavan Ltd. v Aliakmon Shipping Cl. Ltd. ("The Aliakmon") [1986] 2 All ER 145.

84 And by other matters such as the lapsing of statutory limitation periods, set-off and estoppel.

85 "The distinction between real and personal rights may be expressed as the distinction between property and obligation, between what I own and what I am owed. The common law observed this distinction strictly." R.M. Goode, Commercial Law 2ed, 1995, Penguin, London, p. 31. (Before the Victorian advent of corporate insolvency law, the importance of the distinction was, primarily, transferability: see section b.ii below.)
will argue that rights of investors in securities are often, as a matter of English domestic law, equitable choses in action. It would be useful, in this context, to look again at the distinction between contractual and proprietary rights, as each of the categories of choses in action, and equitable property, has a personal (and not proprietary) flavour.

b. Nature of choses in action

It has been noted that a chose in action is property in an intangible. To understand the nature of choses in action it is helpful briefly to look at their history.

(i) The category

"In its primary sense the term chose in action includes all rights which are enforceable by action - rights to debts of all kinds, and rights of action on a contract or a right to damages for its breach; rights arising by reason of the commission of a tort or other wrong; and rights to recover the ownership or possession of property real or personal."\(^{86}\) Over the course of the last three centuries choses in action, in the financial world, began their long journey from intangibility to paper (before, with computerisation in the mid 20th century, starting the journey back again). "During the 16th century the conception of a chose in action was extended from a right to bring an action, to the documents which were the necessary evidence of such a right. When the law had reached this point, it was inevitable that the many new documents, which the growth of the commercial jurisdiction of the common law courts was bringing to the notice of the common lawyers, should be classed in this category. Thus, during the 17th, 18th and 19th centuries, such documents as negotiable instruments, shares, policies of insurance, and bills of lading, were declared to be choses in action....."\(^{87}\)

\(^{86}\) Holdsworth, op. cit., p. 516.

\(^{87}\) Holdsworth, op. cit., pp. 527, 528.
(ii) **Restrictions on assignment**

Choses in action were originally treated as personal rights of action, and for that reason were not assignable. Maintenance (or the abusive trafficking in rights of action) was a serious concern in medieval England. Therefore the general restriction on assignment of choses in action persisted long into the modern era, until it was eroded by the development of exceptions to accommodate the needs of commerce. "Negotiable instruments were assignable by the law merchant. Stocks and shares were in early days expressly made assignable by charter or Act of Parliament." 91

(iii) **Personal or Proprietary**

Before the beginning of corporate insolvency law, a key characteristic distinguishing personal rights from proprietary rights was their non-assignability. Therefore, when the benefit of choses in action became

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88 "In the language of Roman law, personal actions were founded upon an obligation; and an obligation might arise either out of contract or tort ... but it is clear that a personal action, brought either on a contract or a tort, is essentially a personal thing ... On that account the common lawyers saw as clearly as the Roman lawyers that such rights of action were personal matters between these two persons. Therefore assignment of such a right of action by the act of the two parties was unthinkable ". Holdsworth, op. cit., p. 520.

89 "In England in the later medieval period, the disorderly state of the country, the technicality of the common law procedure, the expense of legal proceedings and the ease with which jurors, sheriffs and other ministers of justice could be corrupted or intimidated made maintenance and kindred offenses so crying an evil, that it was necessary to prohibit sternly anything which could in the smallest degree foster them." Holdsworth, op cit p 523. For the modern approach of the courts to this issue, see Trendtex Trading Corp. v Credit Suisse [1982] A.C. 679.

90 "It is clear from these illustrations that the law started from the idea that a chose in action is a personal non-assignable right. But, having found that a rigid adherence to the theory was in practice inconvenient and impossible it has partially modified it in many different directions; and these modifications have been carried further both by equity and by the legislature. The result is that, though very little is left of the broad principle from which the law started, it is necessary to know it, because it is still operative unless it has been modified to the common law, by equity, or by statute." Holdsworth, op cit, p.541.

91 Holdsworth, op cit, p.542

92 "The classic common law criteria of 'property' have tended to rest a twin emphasis on the assignability of the benefits inherent in a resource and on the relative permanence of those benefits if unassigned...This preoccupation with assignability of benefit and enforceability of burden doubtless owes much to the fact that the formative phases of the common law concept of property coincided with a remarkable culture of bargain and exchange. Non-transferable rights or rights which failed on transferee were simply not 'property'. Within
in some cases assignable they arguably became, in those cases, proprietary. "The result [of assignability] has been that some of these choses in action have changed their original character and become very much less like merely personal rights of action, and very much more like rights of property .... [this is] a branch of law, which comes at the meeting place of the law of property and the law of obligation". 94

Where assets are held in custody, the difference between personal and proprietary rights is important in the event of insolvency. A chose in action, which is held in custody, is personal as against the obligor, and will clearly be affected by the insolvency of the obligor. However, as against the custodian, it is capable of being proprietary and of being unaffected by its insolvency. In other words, securities (being choses in action) can be proprietary only where there is intermediation, or custody. It is only in the context of custody that the proprietary nature of securities has meaning. The proprietary nature of securities is their enforceability though the hands of a custodian (or, more precisely, in its insolvency). Broadly speaking, the law of property in the securities markets is the law of insolvency as it relates to custodians.
a. Nature of Equitable Property

Like choses in action, equitable proprietary rights began their legal history as personal rights, and then evolved into hybrid rights that are capable, upon a custodian's insolvency, of being proprietary.\(^{95}\)

Historically and conceptually, equitable property begins with the personal fiduciary obligation (which the law of equity implies) of a trustee to hold trust property for the benefit of the beneficiary. This personal obligation give the beneficiary correlative personal rights against the trustee, to require that the obligation be observed. The gap between a personal right against the trustee in respect of trust property and a proprietary right in the trust property that will survive the trustee's insolvency is bridged by the convenient equitable doctrine of conversion: equity regards that as done which ought to be done. The law regards the trust property as belonging to the beneficiary, in equity, because the trustee should account to the beneficiary for the trust property.\(^{96}\)

95 See Maitland, Selected Essays, Cambridge University Press, 1936, The Unincorporate Body, pp 129, 130: "A right which in ultimate analysis appears to be *jus in personam* (the benefit of an obligation) has been so treated that for practical purposes it has become equivalent to *ius in rem* and is habitually thought of as a kind of ownership, "equitable ownership". ....It was made by men who had no Roman law as explained by medieval commentators in the innermost fibres of their minds." See also Holdsworth, op. cit., Volume IV, pp. 432, 433, 434: "In early days the relation between the feoffee to uses and the feoffor or cestui que use was of a strictly personal character. [But the nature of the right was extended to bind other persons]...In fact in 1466 it had been laid down that the conscience of any one was affected who obtained the estate in the land from the feoffees with notice of the use; and, applying the principle that one who was enfeoffed without consideration held to the use of the feoffor, the conclusion was easy that the conscience of any one to whom the estate was gratuitously conveyed by the feoffees to uses, was likewise bound whether or not they had notice of the use. But further than this the Chancellor would not go. The conscience of a purchaser for value without notice from the feoffees was not affected, and therefore he was not bound by the use....These conclusions had been reached by the beginning of the sixteenth century; and when they had been reached, the root principle of the equitable ownership of modern English law had been ascertained.

It was a wholly unique form of ownership which the chancellor had thus developed from a conscientious obligation of a very personal kind. It was not a true *jus in rem* because it was not available against the whole world. There were or might be many persons as against whom it could not be asserted. Then, although it rested on the chancellor's power to proceed against the person whose conscience was affected by notice of the use, it was far more than a mere *jus in personam*. It could be asserted against many persons besides the original feoffment. A right of so peculiar a kind could probably never have been invented by lawyers who had a firm hold of the Roman distinction between *dominium* and *obligatio*, or the modern distinction between *jura in rem* and *jura in personam*.

96 "Historically the courts of equity acted in personam .... But, although the basis of the equity jurisdiction was and still is, founded on an order in personam, the courts of equity evolved the doctrine that, in the eyes of equity, that which ought to have been done is treated as having been done. Thus under a specifically enforceable contract for the sale of land, the purchaser is treated in equity as the owner of property whether
Another convenient equitable doctrine is that of tracing, a process\(^{97}\) whereby a process whereby proprietary remedy rises in favour of the beneficiary upon the default of the trustee. "It has allowed him to pursue a "reified" trust-fund from investment to investment: in other words, to try to find some thing for which the original thing has been exchanged by means of a longer or shorter series of exchanges. The ideas of a trust-fund which is dressed up (invested) now as land and now as current coin, now as shares and now as debentures seems to me one of the most remarkable ideas developed by modern English jurisprudence."\(^{98}\)

b. Conclusions

The question of whether custody assets are personal or proprietary is important in determining whether they will be at risk on the insolvency of the custodian. Much of the custody portfolio consists, under English law, of equitable choses in action. Equitable property and choses in action, considered in abstract terms, share the characteristic of being partly personal and partly proprietary\(^{99}\). However, their ambiguous nature is of limited practical relevance because, as has been indicated, the importance of proprietary status arises not in the abstract, but in insolvency.

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or not an order for specific performance has been made. Again, in the law of trusts a beneficiary is treated as immediately entitled to his interest in the trust property whether or not an order for the execution of the trust has been made against the trustee. In this way the plaintiffs rights, although founded on the ability of the court to make an order in personam against the other contracting party or the trustee, becomes an interest in the property itself, an equitable interest. Once the position is reached that an order for specific performance could have been made against the legal owner if the matter had been brought before the court, thereafter the legal owner holds the property shorn of those rights which the court of equity would decree would belong to another." Swiss Bank Corp v Lloyds Bank [1979] 2 ALL ER 853 per Browne-Wilkinson J at 865, 866. See also A.G. for Hong Kong v Reid [1993] WLR 1144, per Lord Templeman at 1146.

97 "Tracing properly so-called is neither a claim nor a remedy but a process". Per Millett J., Boscawen v Bajwa [1995] 4 All ER 769 at 776.

98 Maitland, Selected Essays, Cambridge University Press, 1936, Trust and Corporation, p. 134. See also In Re Oatway, Hertslet v Oatway [1903] 2 Ch 356, per Joyce J. at 359. "It is a principle settled as far back as the time of the Year Books that, whatever alteration of form any property may undergo, the true owner is entitled to seize it in its new shape if he can prove the identity of the original material."

99 "The ambivalent quality, for example, of the contractual chose in action provides a constant reminder of the fluid nature of [the] classifications ['contractual' and 'proprietary']." [N]o quantum leap differentiates contract from 'property', for 'property' has no clear threshold." Kevin Gray, Property in Thin Air, pp. 302,303.
In the late 19th century and early 20th century, there was uncertainty as to the correct treatment of choses in action in insolvency. Today, the position is clear. Not all the assets held by an insolvent are available for distribution among its creditors, but only those which belong to it. Distributable assets do not include assets held by the insolvent but owned by third parties, whether or not that third party ownership is equitable, and whether or not the assets are choses in action.

However, in seeking to benefit from this rule in the era of electronic custody, clients face certain legal risks. Computerisation affects both the legal nature of the custody securities, and that of the custody relationship, as discussed in chapters 3 and 4.

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100 See Holdsworth op. cit., p.543

101 In the case of the bankruptcy of an individual, assets held by the individual on trust are excluded from his estate by Section 283(3)(a) of the Insolvency Act 1986. In the case of corporate insolvency, the authority for the exclusion of trust assets lies in the general principle that only assets owned by the company form part of its estate, as reflected in caselaw. See for example, Barclays Bank Ltd. v Quisclose Investments Ltd. [1968] 3 All ER 651 and Re Kayford Ltd. [1975] 1 All ER 604 and other cases discussed in R.M. Goode, Principles of Corporate Insolvency Law, London, Sweet & Maxwell, 1990, at 55 and 56.
Chapter 3. Computerisation and Securities

In the late 20th century, the securities markets have seen a growing trend towards computerisation. Paper instruments and certificates are replaced by electronic records, maintained by the various intermediaries through whom investors' securities are held. Because these databases are in general maintained by intermediaries and not issuers, increased computerisation means increased intermediation.

The reason for computerisation is the efficiency of electronic technology. However, it has far-reaching legal consequences. In the absence of clarifying legislation and case law, these consequences have not been fully analysed. Computerisation has brought both a new order of operational efficiency and a new order of legal uncertainty to the securities markets. The following is an attempt to reduce this uncertainty by suggesting an approach to the legal consequences of computerisation.

These consequences fall into two categories: changes to the legal nature of securities, and changes to the legal nature of the custodial relationship between investors and the intermediaries with whom they have a direct relationship. This chapter will discuss the effect of computerisation on securities. Its effect on the custodial relationship will be discussed in the next chapter.

Commercial arrangements relating to computerised securities are characteristically cross-border, and a legal analysis of them necessarily involves a consideration of private international law. However, the starting point of this analysis is the position under English domestic law, and the following discussion is made on the basis that English domestic law governs the commercial arrangements relating to computerised securities. While somewhat artificial, it is a necessary preliminary to a consideration of the position under English private international law, which will follow in chapters 6 and 7 below.


103 "Market participants have worked hard to simplify the flow of securities across borders through the development of global custody networks, international central securities depositories (ICSDs) and links between national central securities depositories (CSDs). The ability to transfer securities in book-entry form has been the basis for these developments." Bank for International Settlements, Cross-Border Securities Settlements, Basle, May 1995, p. 46.


105 although where foreign law is not proved, the courts apply English law: see chapter 6 section C.2.
A. Computerised Securities

The shift away from paper and towards electronic or book-entry records is called dematerialisation. Securities may take a variety of forms in wholly or partially dematerialised environments. These will be referred to as Computerised Securities. They include the following:

1. Immobilised Securities

Immobilisation has been defined as "The storage of securities certificates in a vault in order to eliminate physical movement of certificates/documents in transfers of ownership". The two major European immobilisation systems are Euroclear and Cedel. "The first on the scene was Euroclear, founded in Brussels in late 1968 by Morgan Guaranty Trust. Cedel was organised and established in Luxembourg within 12 months, commencing operations in 1971...The clearing systems were founded because they were necessary for the construction of the international bond market. Before the foundation of the automated systems both issue and trading depended on a system of physical delivery and transfer. The system could not keep up with the increasing number of trades and issues with the result that by 1967 the position was unsatisfactory and the system in difficulties. ...The underlying purposes of the two systems are ease of transfer of bonds and security. So long as most investors within the international bond market do not wish to have actual physical possession of their bonds, a physical delivery on initial issue or subsequent transfer would constitute a time-consuming, expensive, potentially insecure, and unnecessary function. Far better that the bonds should physically always remain in a safe and authorised depositary, and transfers merely be effected on the records of the two clearing systems. Risks are further reduced by the use of the systems because, when settlements are effected within them, they can be carried out by simultaneous transfers of cash and securities within the systems.""
2. Global Securities

On the closing of an issue of eurobonds, the paper customarily issued by the issuer is not made up of definitive bonds, but it takes the form of a global bond in substitution for the entire issue of definitives. The global bond is held by a common depository. The common depository agrees, in a letter of acknowledgement to the issuer, to hold the global for Euroclear and Cedel, who (in accordance with their General Terms and Conditions) in turn hold their interests in the global bond for those of their participants to whose accounts interests under the global are credited. The issuer promises to pay principal and interest to the holder of the global.

The primary reason for issuing globals instead of definitives is the desire to avoid adverse US taxation consequences. In the case of temporary global bonds, at the end of a 40 day "lock up" period, definitives are issued to a depository acting for the relevant clearing system, upon the certification by Cedel or Euroclear that the participants to whom definitives are to be issued have in turn certified that the investments are not beneficially owned by US persons. Further, while definitives are security printed, globals are not. Because of the expense of security printing, bonds are sometimes issued in permanent global form and definitives are never issued. It is also customary for euronotes and eurocommercial paper to be issued in permanent global form. The temporary global is exchangeable wholly or in part at the request of the holder for definitives, and is reduced in value pro rata the value of definitives issued in exchange. Partial exchanges are endorsed on the global, which is cancelled when it is exchanged in full. A permanent global is generally only exchangeable for definitives upon the default of the issuer or the closure of the clearing system. The issuer promises to pay principal and

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108 On the risks addressed by immobilisation, see John Marius, Advice concerning Bills of Exchange of, 1656, quoted in Milnes Holden The History of Negotiable Instruments in English Law, University of London, Athlone Press, 1955 p. 46: "Never make your Bills of exchange payable to such a one (naming his name) or to the bearer hereof, which is very dangerous...... for a bill which shall be made payable to Robert W or Bearer hereof, may chance to miscarry, or come into a wrong mans hands....."

109 i.e. bonds issued in a currency other than that of the jurisdiction of the issuer.

110 i.e. short term promissory notes denominated in a currency other than that of the jurisdiction of the issuer.

111 i.e. short term debt instruments denominated in a currency other than that of the jurisdiction of the issuer.
interest to the holder of the global. (In the case of temporary globals, the holder is however only entitled to payment if the issuer defaults in its obligations to issue definitives on request.) 112

3. Repackaged Securities

The chief example of a repackaged security is a depository receipt. Underlying securities are legally acquired by a depository (with certificates held on its behalf by a custodian). The depository holds its interest in the underlying securities on trust for holders of depository receipts. The identity of depository receipt holders from time to time is determined by reference to a register maintained by the depository. Securities are repackaged primarily to change their jurisdiction. Originally developed in the United States, an American depository receipt (ADR) programme permitted US investors to invest indirectly in non-US securities where direct investment in such securities was not possible or not attractive for currency, administrative, settlement, taxation, or regulatory reasons.

4. Dematerialised Securities

Dematerialisation is defined as follows in The G30 Report:113 "The elimination of physical certificates or documents of title which represent ownership of securities so that securities exist only as computer records." In the UK, examples of dematerialised registered securities are gilts held within the Central Gilts Office, and equities and other registered corporate securities within CREST.

112 If the issuer fails to issue definitives on default, the following enforcement problem arises. Investors have no locus standi against the issuer, as they are not the holders of notes. Their rights under the global may be enforced through a trustee (in cases where a trustee is appointed). However, where not trustee is appointed, their rights under the global can only be enforced through the common depository; in practice common depositories are unwilling to enforce on behalf of investors as they have a customer relationship with the issuer.

To overcome this problem, it is usually provided that, if the issuer fails to issue definitives within 30 days of default, the obligations of the issuer under the global will become void; in their place, new obligations on the issuer arise under a deed poll executed directly in favour of investors (i.e. participants in Euroclear and CEDEL having entitlements under the global credited to their accounts). This provision will be referred to as "the Disappearing Global".

The above categories are not exclusive; for example, global securities are always also immobilised i.e. held through Euroclear and Cedel;¹¹⁴ depository receipts are usually issued in global as well as definitive form, and global depository receipts are immobilised through Euroclear, Cedel and/or the Depository Trust Company of New York ("DTC").

Securities may be held through chains of intermediaries with any number of links. For the sake of simplicity, the term "Investor" will be taken here to mean an investor whose interest is as direct as possible, i.e. (in the case of Immobilised and Global Securities) the participant in the clearing system; (in the case of Repackaged Securities) the holder of the depository receipt; and (in the case of Dematerialised Securities) the registered holder of registered securities and the participant in the clearing system in the case of bearer securities. The term Computerised Securities will be used to mean the interest of the Investor in each of the above, and the term Physical Securities to mean securities which are not Computerised Securities. It will be assumed that the intermediary having a direct link with the issuer is located in England.

It is important to establish the effect of the computerisation on the legal nature of securities. The issue falls naturally into two parts, as securities fall broadly into two categories: bearer securities and registered securities. The precise difference between them is a matter of extensive debate, but (in broad terms) may be summarised as relating to the procedure for their legal transfer. A bearer security promises on its face to pay the bearer, and the chose in action against the issuer is considered at law to be locked up in the instrument issued in respect of it¹¹⁵. Because they consist of tangible instruments, bearer securities are choses in possession. In general, whoever possesses the instrument legally owns the bearer security which is transferable by delivery of the instrument¹¹⁶. In this sense, bearer instruments are like cash. Examples of bearer securities are bearer bonds and certificates of deposits. In contrast, legal ownership of registered securities

¹¹⁴ "Clearly, definitive bonds, having a physical existence can be removed from the clearing system and therefore traded, both within and outside the clearing systems. By contrast, a global bond must be retained within the system, and transfers can only be effected by book entries between accounts within the systems." Prime, International Bonds and Certificates of Deposit, p. 233.

¹¹⁵ See R.M. Goode, Commercial Law, 2ed, Penguin, London, 1995, p. 53. If the bearer security is a debt security, the instrument is a document of title to debt.

¹¹⁶ Delivery of possession generally confers legal title; however if the deliveror intends to retain legal title, a bailment generally arises.
is determined prima facie by the register of members of the issuer. In order legally to transfer a registered security, it is necessary for the register to be amended in favour of the transferee. Examples of registered securities are equities¹¹⁸ and gilts¹¹⁹. Bearer securities will be considered in section B below and registered securities in section C.

B Bearer Computerised Securities

The most important example of the computerisation of bearer securities is the eurobond markets, where most securities are both immobilised and issued (initially at least) in global form.¹²⁰

Because eurobonds are characteristically immobilised and/or issued in global form, these forms of computerisation will be considered in this section. The other forms of computerisation, repackaging and dematerialisation, will be discussed in the section on registered securities below.¹²¹

¹¹⁷ Societe Generale de Paris v Walker (1885) 11 App. Cas 20. While certificates may be issued, they are not documents of title, but merely documents evidencing title.

¹¹⁸ i.e. shares of companies

¹¹⁹ i.e. registered debt securities issued by the government of the United Kingdom through the Bank of England

¹²⁰ "...definitive Eurobonds are usually warehoused with a 'common depository' for the two clearance systems Euroclear and Cedel. Euroclear and Cedel hold the bonds for the account of their respective securities account holders in each clearance system; where a transfer takes place it always takes place between one account holder of the clearance system and another; consequently, all transfers are effected by an electronic book entry system without any movement of the physical definitive Eurobonds." Ravi C. Tennekoon, The Law and Regulation of International Finance, Butterworths, London 1991, p. 167.

¹²¹ In practice, the underlying securities in depository receipt programmes are generally limited to registered equities. In this jurisdiction, the major initiative for dematerialisation is CREST, which relates to registered corporate equities and debt. However, certain bearer securities may be dematerialised in the UK through the Central Moneymarkets Office ("CMO"). It is also true that, although generally global securities are only issued in respect of bearer securities, registered securities may be issued in global form and immobilised in a clearing system. Of course, a global form of registered security is not the exact equivalent of the global form of bearer securities. It is not a global note but a global certificate, for it does not constitute but merely represents the underlying securities, which are not and cannot be constituted by paper. While the underlying securities of a bearer global may be unissued, those of a registered global are unissuable. The exact status under English law of a bearer global is somewhat uncertain, but English law treats a registered global in the same way as a registered definitive, as evidencing the title of the person entered on the register as the owner of the securities. Indeed, the terms "global" and "definitive" in the context of registered securities owes more to practice borrowed from the bearer markets than to legal analysis. Another difference between bearer and registered globals is that the Disappearing Global problem discussed above does not arise with registered globals, for (as there is no need for any definitive paper to be issued on the issuer's default, but merely for reregistration from the name of the global holder into the name of the investors) the enforcement difficulties driving the Disappearing Global should not be present.
The major impact of computerisation on bearer securities appears to be the loss of negotiable status.

In this discussion the term Bearer Computerised Securities will mean Computerised Securities which are derived from bearer securities.122

1. Negotiability

The secondary markets in bearer securities have traditionally benefited from the doctrine of negotiability. A negotiable instrument has two attractive features. Firstly, it is transferable without formalities123. Secondly, honest acquisition confers good title (even if the transferor did not have good title124). Thus, market transfers are rapid and reliable.125 The negotiable instrument is "a privileged creative in the law"126 because of "the unassailable position of the bona fide holder for value"127 or the holder in due course, who takes the instrument free from prior equities or defects in the title of the transferor. The general view is that these benefits are not available to securities which are not negotiable instruments.128

122 Derived because (in the case of Immobilised) the underlying securities are in bearer form or (in the case of Global Securities) the definitive securities are or would if issued be in bearer form.

123 By physical delivery, or by endorsement and delivery in the case of certain instruments requiring endorsement, such as cheques.

124 Provided the instrument is negotiated prior to maturity: see Brown v Davies (1789) 100 ER 466

125 See J S Ewart, Negotiability and Estoppel, (1900) 15 LQR ixv 135 (1900), pp. 140, 141: "The truth is that 'negotiable' has an original and an acquired signification. Originally, it meant transferable; but afterwards it was used to indicate the effects of transfer, namely, that the transferee (1) took free from equities, and (2) could sue in his own name". (Ewart was writing before the implementation of s. 136 of the Law of Property Act 1925 which generally permitted the legal assignment of choses in action, subject to prescribed formalities).


128 "The object of the law merchant as to bills and notes ... is to secure their circulation, therefore honest acquisition confers title. To this despotic but necessary principle, the ordinary rules of the common law are made to bend." Ewart, op. cit., at 135 quoting Byles J, Swan v NBA, (1863) 159 ER 73; "The law merchant validates in the interests of commerce a transaction which the common law would declare void for want of title or authority." Ewart at 136, quoting Baron Wilde, Swan v NBA 1862 7 H&N 634.
An instrument may acquire negotiable status either by statute\textsuperscript{129} or by commercial usage, as reflected in the law merchant.\textsuperscript{130} In its medieval origin, the law merchant consisted of the decisions of the borough, fair, staple and admiralty courts in commercial disputes. These were based on mercantile custom. In the Tudor era, such disputes began to be heard in the common law courts where, in the early 17th century, it was established "... that a custom prevailing between merchants could originate a legal duty."\textsuperscript{131} The law merchant as it relates to negotiable instruments was consolidated by Lord Mansfield in the 18th century and codified by the Bills of Exchange Act 1882.\textsuperscript{132}

It is considered that negotiability is important for the integrity of the secondary markets in bearer securities, as it generally prevents secondary market transactions from being unscrambled because of defects in the title of previous holders of the securities in question, and obviates the need for purchasers to investigate the title of vendors.\textsuperscript{133} It is generally\textsuperscript{134} established that bearer

\textsuperscript{129} e.g. The Promissory Notes Act 1704 or the East India Company Bonds Act 1811.

\textsuperscript{130} "As regards English law, there are only two ways in which an instrument can acquire the characteristic of negotiability: by statute or by mercantile usage in the English mercantile world. An instrument cannot become negotiable by agreement between the parties or by custom which is not general." Philip Wood, Law and Practice of International Finance, London, Sweet & Maxwell, 1980, section 8.3(4).

\textsuperscript{131} Holden op. cit., p. 32.

\textsuperscript{132} The general view is that the Act did not alter the law merchant, and so is persuasive authority as to the law merchant as it relates to instruments other than those expressly covered by it (bills of exchange, promissory notes and cheques are expressly covered). "It was not intended, in the first place, to alter the existing law, save by elucidating obscurities." Fifoot, op. cit., p. 451.

\textsuperscript{133} "It is clearly advantageous to a holder of a document to know that it is in a category of documents treated by law as fully negotiable in the narrow sense since a holder is thereby freed from the responsibility of enquiry into his transferor's title. This can be considered to be of the utmost importance in the case of negotiable securities available on a secondary market. A market in securities must function speedily with people being able to implement immediately their decisions to buy and sell." Terrence Prime, International Bonds and Certificates of Deposit, Butterworths, London 1990, p. 238. See also Ravi C. Tennekoon, The Law and Regulation of International Finance, Butterworths, London 1991, p. 163: "In practice the issue of Eurobonds in the international markets would be made difficult unless the international investment community had no doubts as to the negotiable character of the Eurobond."

\textsuperscript{134} Certain provisions that have been incorporated in commercial paper have been considered to affect their status as promissory notes negotiable under section 83 of the Bills of Exchange Act 1882. Such provisions include withholding tax grossing up provisions (having the result that the note is not a promise to pay a sum certain) and restrictions (driven by U.S. regulatory requirements) on negotiation of the instrument to nationals of certain countries (so that the note is not an unconditional promise to pay) and the enfacement of guarantees on the instrument. Such provisions must be considered on a case by case basis.
security in the secondary markets which are Physical Securities are negotiable instruments.\textsuperscript{135} It might therefore seem desirable to argue that the movement of bearer instruments into computerised form has not been at the expense of their negotiable status.\textsuperscript{136} There is no statutory confirmation of the negotiable status of Bearer Computerised Securities\textsuperscript{137}. Therefore, to show that Computerised Securities are negotiable, it would be necessary to argue that they

\textsuperscript{135} Domestic corporate bonds: \textit{Re General Estates}, 1868, L.R.3 C 758; \textit{Higgs v Northern}, 1869, L.R.4 ex 387; \textit{Re Imperial Land Co}, 1870, L.R. 11 ex 478; \textit{Bechuanaland Exploration Co v London Trading Bank} [1898] 2 Q.B. 658.


Scrip for bonds (i.e. certificates acknowledging the holders entitlement to be issued with bonds): \textit{Goodwin v Robarts} (1875), L.R. 10 Ex 76.

Scrip for shares (i.e. certificates acknowledging the holders entitilements to be issued with shares): \textit{Rumball v Metropolitan}, 1877, 2 Q.B.D. 194.


The above references are quoted in Ewart, op. cit., p. 156. See also the following:-

Bearer bonds whether foreign or domestic, corporate or government: \textit{Edelstein v Schuler} [1902] All ER Rep 884.


The more recent introduction of euro-notes and euro-commercial paper to the London secondary markets raised the question of whether these new forms of bearer security were negotiable in the absence of clear statutory or judicial authority. The general consensus in the legal community is that these physical instruments have become negotiable on the basis of commercial custom in London.


\textsuperscript{137} It cannot be argued that Computerised Bearer Securities are negotiable as promissory notes under section 83 of the Bills of Exchange Act 1882 for a number of reasons, the chief of which is that they are not in writing.
are negotiable under the law merchant. This argument might take two forms. The first is that Bearer Computerised Securities are the same as the Physical Securities from which they derive, which are already recognised as negotiable by the law merchant. The second is that Bearer Computerised Securities form a new class of negotiable instrument which has been so recognised.

The first argument is not sustainable. As indicated above, the term "Computerised Securities" refers here to the interest of the Investor in Immobilised and Global Securities. It is this interest which is dealt in the secondary markets and for which the benefits of negotiability are desired. This interest is fundamentally different from the Physical Security from which it is derived, in two respects. Firstly, the holder in due course of a Physical Security which is a negotiable instrument has possession of it; in contrast, the Investor in a Bearer Computerised Security does not have possession of any underlying Physical Securities, and his interest is intangible. Secondly, the holder in due course of a physical negotiable instrument can sue directly on it in its own name; in contrast, the investor in Bearer Computerised Securities (other than Dematerialised Securities138) cannot. Its rights against the underlying issuer can in general only be enforced through an intermediary.139 Because Bearer Computerised Securities are intangible and (generally) indirect they are not the same as any Physical Securities that may underlie them.140

2. A new class of negotiable instrument?

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138 In the CMO, the investor in a Dematerialised Security is given a right to sue the issuer directly, under the terms of an Agreement for the Dematerialisation of CMO Instruments made between the Bank of England and CMO members.

139 In the case of Immobilised Securities, the investor has directly enforceable rights only against the clearer, and not the underlying issuer. In the case of Global Securities the investor's rights (in the absence of default) are enforceable only against the clearer, which has rights against common depository, which in turn has rights against the issuer. Where a trustee has been appointed, the investor has rights against the trustee, who in turn has rights against the issuer. (It is true that, where no trustee has been appointed, upon the default of the issuer, the rights of the investor under the Global Securities may be replaced by direct rights against the issuer under a deed of covenant. However, as they arise under a separate instrument, these are not rights under the Global Securities.)

140 It will be argued below that the intangible and indirect nature of Computerised Securities also prevents them from forming a new class of negotiable instrument.
Is it possible to argue, then, that the Bearer Computerised Securities form a new class of negotiable instrument recognised by the law merchant? There is no direct judicial authority to this effect. It might therefore be argued that they are negotiable within the law merchant on the basis of commercial practice (so that when the question does come before the courts, it is safe to assume that their negotiable status will be judicially recognised).

In trying to anticipate the courts in this matter, it is helpful to look at how they have acted in the past. Although "... the courts have hesitated before admitting new entrants to the class", judicial recognition of instruments as negotiable (from the recognition at the turn of the 13th century of Bills of Exchange to the recognition of share warrants of the turn of the 19th century has followed commercial practice.

The mercantile courts have traditionally attracted the custom of merchant litigants by this approach. Fifoot comments, "As methods of business alter, so must the law adapt to new conditions".

It might therefore be argued that (although not the same as the Physical Securities that may underlie them), Bearer Computerised Securities are a new class of instrument that are negotiable within the law merchant, because the law merchant follows commercial practice. Bearer Computerised Securities have evolved from Physical Securities as a matter of operational convenience, without any commercial intention that their legal incidents should differ from those of

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141 Holden, op. cit., p. 83.
144 It does not matter that the commercial practice in question is not mercantile, i.e. that the computerisation of securities is a function of the practice of financial institutions and not of merchants. It was held in Woodward v Rowe (1666) 2 Keb 105,132 that "... the law merchant is the law of the land, and the custom is good enough generally for any man, without naming him merchant", changing the rule from a case reported in 1612 in which the plaintiff failed because the dependant was "not in a merchant, but a gentleman". Fifoot, op. cit., p. 440.

The market usage of treating an instrument as negotiable must be notorious, certain and reasonable. See Kum v Wah Tat Bank Limited (1967) 2 Lloyd's Rep 437 and General Reinsurance Corporation and Others v Forsakringsaktiebolaget Fennia Forum (1983) 1 Q.B. 856.
145 Fifoot, op. cit., p. 452
the Physical Securities from which they derive. It might perhaps be assumed that the law merchant will not defeat commercial intention, and honour the principle that "the law must be for trade, and not trade for the law".  

There is ample authority that the law merchant is a dynamic branch of law, evolving to reflect changing commercial practice from time to time. In the anomalous case of Crouch v Credit Foncier Co (1873) the court rejected the argument that an instrument was negotiable at law because it was so treated by the business community, and held that no new types of negotiable instrument could be recognised; modern usage could not alter the law merchant. This view was in effect overruled by the decision in Goodwin v Robarts, which conclusively rejected the view that "the door [is] to be now shut to the admission and adoption of usage... as though the law had been finally stereotyped and settled...". Commentators are united in the view that the Bills of Exchange Act 1882, while codifying the law of negotiable instruments, has not arrested its development. This view is confirmed by the case of Bechuanaland, in which bearer debentures were held to be negotiable. "It was, indeed, for the judge to decide, in accordance with the law of the Bills of Exchange Act, what were the necessary elements of negotiability. But, if it were proved that business men habitually treated a document as possessing those elements, there was nothing to prevent its admission within the charmed circle."  

146 Fifoot, op. cit., p. 444  
147 L.R. 8 Q.B. 374  
148 L.R. 10 Ex 76, affirmed by H.L. 1 App Cas 476  
149 This language was echoed in the Privy Council some 70 years later in Bank of Baroda, Ltd. v Punjab National Bank, Ltd. [1944] AC 176 at 183, as follows: "The law merchant is not a closed book, nor is it fixed or stereotyped".  
150 Section 97(2) of the Act provides that "The rules of common law including the law merchant, save as so far as they are inconsistent with the express provisions of this Act, shall continue to apply to bills of exchange, promissory notes and cheques". Such rules, as they may develop from time to time, also apply a fortiori to other types of negotiable instrument.  
152 Fifoot, op. cit., p. 453
Further, the fact that Bearer Computerised Securities have existed for a relatively short time does not prejudice their candidacy for negotiable status. "We cannot concur in thinking that if proof of general usage has been established, it would have been a sufficient ground for refusing to give effect to it that it did not form part of what is called ‘the ancient law merchant’:.” 153 Since the later 19th Century, the test has been general, and not ancient, usage. There are several examples of the robust approach of the courts in recognising new classes of negotiable instrument. 154 Thus, in principle, the law merchant is capable of recognising Bearer Computerised Securities as a new class of negotiable instrument. The question is whether it has in fact done so.

3. Arguments against negotiability

It will be argued here that the law merchant has not recognised Bearer Computerised Securities as a new class of negotiable instrument, primarily because of the intangible nature of Bearer Computerised securities.

a. indirect

One obstacle to treating Bearer Computerised Securities as negotiable is their indirect nature. Manisty J considered US share certificates in *London and County Banking Company Ltd. v London and River Plate Bank Ltd.* (1887)155 and commented, "Now it seems clear to me that this instrument could not be sued upon by the person holding it *per tempore*, and could therefore not be negotiable." The ability of the holder from time to time of an instrument to enforce it against its issuer in his own name has generally been taken to be an essential criterion of negotiability. 156 It was noted (at section [2] above) that, in general, an

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153 per Cockburn C.J., *Goodwin v Robarts* (1875) LR 10 Exch 337 at 356

154 See, for example, Lord MacNaghten in *London Joint Stock Bank v Simmons* [1892] A.C. 201, at 224: "[Cedulas] are treated as negotiable instruments. I do not see on what grounds they are to be denied the quality of complete negotiability. In a matter of this sort, it is not...desirable to set up refined distinctions which are not understood or are uniformly and persistently ignored in the daily practice of the stock exchange."

155 20 QBD 232, at 266

156 See also *Crouch v Credit Foncier Co* per Blackburn J.
Investor in Computerised Securities does not have directly enforceable rights against the issuer.\textsuperscript{157}

However, an alternative view has been expressed. In the past the London legal community considered this question in relation to physical eurodollar bonds constituted under a trust deed which imposed limitations on bondholders' rights to sue the issuer so that generally only the trustee had rights of enforcement, and bondholders were able to sue the issuer, only if the trustee failed in its duties on their behalf. One leading counsel argued that the instruments were not negotiable because on the face of the bonds the person holding them for the time being was prevented from suing on them in his own name. Another leading counsel argued that the instruments were negotiable, and that the requirement of negotiability was not that the holder should have an unrestricted right to sue, but that in circumstances where he is given such a right, he should not need to sue in the names of prior holders. For this reason, the indirect nature of Computerised Securities may not necessarily be incompatible with negotiable status.

b. intangible

The clearer argument against Computerised Securities being negotiable is their intangibility. The early negotiable instruments (bills of exchange and promissory notes) were recognised as negotiable because they were like money, and used by merchants as an alternative method of payment for goods.\textsuperscript{158} Indeed the test of negotiability has been held to be that the instrument should pass from hand to hand like money\textsuperscript{159} and

\textsuperscript{157} (Even in the case of Dematerialised Securities in the CMO, the right of the investor to sue the issuer does not arise under an instrument, but is merely contractual, arising under the Master Dematerialisation Agreement.)

\textsuperscript{158} The term "money" is said in its strict sense, as current coin and bank notes, rather than credit, or the balance of a bank account. See Mann, The Legal Aspects of Money, p. 5: "Bank accounts, for instance, are debits, not money...".

"A Bill of exchange is a security, originally invented among merchants in different countries, for the more easy remittance of money from the one to the other, which since spread itself into almost all pecuniary transactions." Blackstone, Commentaries, Book II. at 466.

\textsuperscript{159} See Lang v Smythe (1831) in which Neapolitan bordereaux were held not to be negotiable because they did not pass from hand to hand in England like money or bank notes.
commentators have argued that the basis of the negotiability of instruments generally is their likeness to money: "Commencing with money, it is usually said that the reason that a thief can pass a good title is because 'of the currency of it; it cannot be recovered, after it has passed into currency'. 160 'Bills of exchange and promissory notes are representatives of money circulating in the commercial world as such.' 161 Money passes with good title because it is money; and notes because they are like money." 162

The rule with money is that property passes with possession. 163 If the basis of negotiability is the likeness of instruments to money, we would expect the same feature (the equation of possession with property) to be an important aspect of negotiability. "For the purpose of rendering bills of exchange negotiable, the rights of property in them passes with the bills...The property and the possession are inseparable." 164 Of course, while the function of the early types of negotiable instrument (bills of exchange and promissory notes) was payment, the function of more recently recognised types (such as share warrants) is investment, and in this respect they are not functionally like money. However the fundamental principle (which arises from the original monetary function of negotiable instruments and, it is submitted, survives a change in that function) is that property passes with possession.

Property is always with the holder, or the person having possession. For this reason, a negotiable instrument must be capable of possession. If it were incapable of possession, it could not confer upon its possessor (a holder) the status of holder in due course.

160 Per Lord Mansfield, Miller v Race 1758 Burr 457

161 Friedlander v Texas (1889) 130 US 416.

162 Ewart, op. cit., p. 152

163 (subject to equitable tracing in some circumstances where money has been paid in breach of fiduciary duty, and received, by a volunteer, or by a purchaser with notice of the breach).

164 Per Eyre C.J. Collins v Martin (1797) 1 B & P 648 at 651
Computerised Securities, being the interest of the Investor, are intangible\(^{165}\). As to whether intangibles are capable of possession for this purpose, it has been argued, in chapter 2 above, that they are not capable of possession at common law, but only in equity. Possession may of course be constructive as well as actual and "Delivery [of a bill or note] means the transfer of possession, actual or constructive, from one person to another".\(^{166}\) Thus actual possession need not be with the holder, but may be with his servant or agent.\(^{167}\) However, as was argued in chapter 2, in order to be capable of constructive possession, an asset must in turn be capable of actual possession. An intangible is capable of neither at law. Although intangible interests are capable of possession in equity, this does not assist in the context of negotiability which is part of the law merchant. As intangibles are incapable of possession outside the realms of equity, Computerised Securities cannot confer upon anyone the status of holder for the purposes of the law merchant, and it is only through such a person that the benefits of negotiability can be enjoyed.

Intangibility poses another problem: an intangible cannot be an instrument. "An 'Instrument' is a Writing, and generally imports a document of a formal legal kind."\(^{168}\) The Bills of Exchange Act defines both bills of exchange\(^ {169}\) and promissory notes\(^ {170}\) as being "in writing" and provides that "'writing' includes print".\(^ {171}\) Byles comments\(^ {172}\) that "Bills of exchange, and promissory notes are usually, but it would seem

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\(^{165}\) Investors have the right to call for underlying Physical Securities; however, if they do so, they convert their investment from a Computerised Security to a Physical Security.

\(^{166}\) *Byles on Bills of Exchange*, 26ed, London, Sweet & Maxwell, p. 97. See also *In re Stapylton Fletcher Ltd* [1994] 1 WLR 1181, per Judge Paul Baker Q.C. at 1195: "...delivery is the transfer of possession..."

\(^{167}\) Byles, op. cit., 98


\(^{169}\) In section 3(1)

\(^{170}\) In section 83(1)

\(^{171}\) In section 2

\(^{172}\) At p. 2988
not necessarily, written on paper. It is conceivable that they might be written on parchment, linen, cloth, leather or any other convenient substitute for paper, not being a metallic substance.” The Interpretation Act 1978 provides that statutory references to “writing” shall, unless the contrary intention appears, include references to printing, lithography, photography and other modes of representing or reproducing words in a visible form. However, none of the above assists in extending the meaning of the term “instrument” to intangibles such as Computerised Securities.

If the basis of negotiability is possession, and if the nature of an instrument is tangible, it is not clear that Computerised Bearer Securities can be either negotiable or instruments. There is no clear authority for treating an intangible as a negotiable instrument, and it may be legally impossible to do so. The way forward may be to extend the concept of negotiability to intangibles. However, this would be a quantum leap from the existing law merchant, and perhaps only achievable by statute.

It is true that in the case of Immobilised and Global Securities, there will be tangible instruments (and directly enforceable rights) in the hands of an intermediary depository or custodian. This does not, however, render the interest of the Investor a negotiable instrument, because all

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173 In section 5 and schedule 1

174 Although an instrument cannot be intangible, there is authority that information stored on the hard disc of a computer may be a document for the purposes of orders for discovery under RSC Ord 24: see Alliance & Leicester Building Society v Ghahremani and Others, (1992) TLR March 19, 1992 and Derby & Co Ltd v Weldon (No 9) [1991] 2 All ER 901, per Vinelott J. However this principle is confined to the context of discovery. In Derby, Vinelott J bases his judgment on the principle in the earlier case of Grant v Southwestern and County Properties Ltd. [1974] 2 All ER 465. In the passage he quotes from that judgment, the policy basis for that decision, which ties it to its litigation context, is clear: “A litigant who keeps all his documents in microdot form could not avoid discovery because in order to read the information extremely powerful microscopes or other sophisticated instruments would be required.” (quoted at 906). Vinelott J goes on to comment, at 906: “The question in this case is not, I think, whether the database is a document but as to the circumstances in which and the means by which a party seeking discovery is entitled to inspect and take copies of that document.” It would therefore be unsafe to seek to extrapolate a general principle from these cases.

175 i.e. the underlying Physical Securities in the case of Immobilised Securities, and the global note itself in the case of globals.

These underlying Physical Securities will also be expressed on their face to be negotiable; this is also a necessary criterion of negotiability: London and County Banking Co v London and River Plate Bank Ltd (1880) 20 QBD 232; Jones & Co v Coventry [1909] 2 KB 1029, quoted in Prime, op. cit., p. 242.
negotiable instruments "are intended to be ambulatory"\textsuperscript{176}. The Physical Securities underlying the Immobilised Securities are (as the term suggests) immobilised in Euroclear or Cedel\textsuperscript{177} and "...neither the TGB [temporary global bond] nor an instrument similar to it has ever been traded in the markets between Eurobond dealers..."\textsuperscript{178} Moreover, Computerised Securities are not expressed to be negotiable on their face because, being intangible, they have no face. Thus the indicia of negotiability are distributed between the Intermediary and the Investor. The physical instrument (expressed to be negotiable) and directly enforceable rights are held by the intermediary, and the "ambulatory" security (i.e. one that passes from hand to hand like money) is held by the Investors.

c. conclusion

In the mid eighteenth century\textsuperscript{179} the following test of negotiability was judicially stated\textsuperscript{180}: "It may therefore be laid down as a safe rule that where an instrument is by the custom of trade transferable, like cash, by delivery, and is also capable of being sued upon by the person holding it pro tempore, then it is entitled to the name of a negotiable instrument, and the property in it passes to a bona fide transferee for value, though the transfer may not have taken place in market overt. But that if either of the above requisites be wanting, i.e., if it be either not accustomably transferable, or, though it be accustomably transferable, yet, if its nature be such as to render it incapable of being put in suit by the party holding it pro tempore, it is not a negotiable instrument, nor will delivery of it pass the property of it to a vendee, however bona fide, if the transferor himself have not a good title to it, and the transfer be made out of market overt."

\textsuperscript{176} Ewart, op. cit., p. 155

\textsuperscript{177} The participant has a right to call for delivery out of Euroclear or Cedel of Physical Securities; however if this occurs, of course, the securities cease to be Immobilised Securities.

\textsuperscript{178} Ravi Tennekoon, op. cit., p. 175.

\textsuperscript{179} Miller v Race 1 Smith L.C. at 259 (1758)

\textsuperscript{180} Blackburn J, Crouch v Credit Foncier (1873) L.R. 8. Q.B. 374 at 381, quoting from the notes to Miller v Race
In the absence of authority to the contrary, the test of negotiability appears to remain firstly, that the instrument should be, by custom of trade, transferable, like cash, by delivery and (subject to the comments at section (a) above) secondly that the instrument should be capable of being sued upon by the holder from time to time.

Delivery is the transfer of possession: "Voluntary dispossession in favour of another is commonly regarded from the side of the former possessor, and called delivery." As an intangible a Computerised Security is incapable of possession and therefore of delivery in the technical legal sense of that term. It would therefore seem that Computerised Securities are neither instruments, nor capable of delivery (nor yet of being sued upon by the holder from time to time) and cannot be negotiable instruments.

This analysis is made under English domestic law. As stated above, arrangements for the issue and transfer of Bearer Computerised Securities are characteristically cross border and therefore involve issues of private international law. English private international law is considered in chapter 6.

Computerised Bearer Securities cannot, it seems, be negotiable instruments for the reasons outlined above, the most compelling of which is their intangible nature. In crossing into the electronic era, the secondary markets in bearer securities crossed an important legal boundary, and left the law merchant. Sections [6.7.8 and 9] below will argue that this may not matter.

4. Intermediate Securities

If Computerised Bearer Securities are not negotiable instruments, what are they?

181 Pollock, Possession in the Common Law, op. cit., p. 44

182 The discussion that follows will continue to use "delivery" in relation to Computerised Securities in its market sense, i.e. the crediting of the purchaser's account with the Computerised Securities in fulfilment of a bargain.
a. functional status

The trend from a paper-based to an electronic environment offers settlement efficiencies and economies of scale. It has been recommended by G30 as an objective for the world's securities markets.\(^{183}\) The New York Uniform Commercial Code provides for dematerialisation.\(^{184}\) The continuing computerisation of securities is inevitable.

As an interim stage in the journey towards pure dematerialisation G30 recommends immobilisation.\(^{185}\) Immobilisation is a form of custody, and the interest of the Investor in the immobilised securities may be described as the interest of a custody client.

Immobilisation involves intermediation, and in this way Immobilised Securities are akin to Global Securities and Repackaged Securities (and indeed the interests of all custody clients). Thus, if one wishes to classify securities according to the manner in which the Investor's interest is held, it is possible to identify three broad types:

1. **Physical Securities**, consisting of or represented by paper issued by the issuer and held directly by the Investor;

2. **Dematerialised Securities**, where the Investor holds, and there is, in fact, no underlying paper; and

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\(^{183}\) Recommendation 3 of the G30 Report is that "Each country should have an effective and fully developed central securities depository, organised and managed to encourage the broadest possible industry participation (directly and indirectly), in place by 1992." The Report goes on to comment (at p. 8) that "Central Securities Depositories should immobilise or dematerialise the issues in safekeeping. While dematerialisation offers particular advantages with regard to efficiency and flexibility, laws and practices of some countries and their markets do not permit dematerialisation. In these situations, consideration should be given to changing such laws to permit dematerialisation."

\(^{184}\) Article 8-102(b)

\(^{185}\) Having commented that in jurisdictions where dematerialisation is not possible, consideration should be given to changing local laws to permit dematerialisation, it goes on to comment: "However, the major goals of the depository can be accomplished by immobilising certificates, provided a system is in place that permits settlement without transfer and re-registration. This is typically accomplished through the use of a system in which the CSD [central securities depository] acts as a nominee for the beneficial owner." (p. 8).
(3) **Intermediate Securities**, where an underlying security is issued (or agreed to be issued) in paper form to an intermediary depository, trustee or custodian ("Intermediary") who holds the underlying paper (directly or indirectly) for the Investor, so that the Investor's interest is intangible and enforceable, not directly against the issuer, but only indirectly, through the Intermediary.

It might be said that Physical Securities belong to the past, Dematerialised Securities to the future and Intermediate Securities to the transitional present.\(^\text{186}\) With Intermediate Securities, the interposition of the Intermediary serves to bridge old (paper-based) and new (electronic) practice.

**b legal nature**

What is the legal nature of Intermediate Securities?

The important point is that the way in which securities are held determines their legal nature. Intermediate Securities are indirect and unallocated.

(i) **Indirect**

It was shown above that the Investor does not in general have directly enforceable rights against the issuer. Its rights in respect of the issuer can only be exercised through the Intermediary.

In the case of Immobilised Securities, underlying Physical Securities are held through Euroclear or Cedel. Each of these clearing systems operates a system akin to global custody,\(^\text{187}\) in that the physical safekeeping of Physical Securities is delegated by the clearer to depositories, which are generally located in the same jurisdiction of the issuer. Thus, there are two levels in

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186 Some might argue that, for this reason, custody (in the sense of safekeeping) is not a long term industry.

187 In its legal structure; the clearers do not in general offer the value-added information based services characteristic of the global custody product.
intermediation. The Investor has rights which are enforceable only through Euroclear or Cedel; the clearer has rights which are enforceable only through its depository; the depository, as holder of the Physical Securities, is their legal holder and therefore has directly enforceable rights against the issuer.

The position with Global Securities is similar, but more complex. We saw that a physical global bond in temporary or permanent form is issued directly to a common depository, which holds it for Euroclear and Cedel, which in turn hold their interest in it for participants who are Investors. Thus, as with Immobilised Securities, there are two levels of intermediation.\textsuperscript{188} Thus, in each case, the underlying property is held for Investors through two Intermediaries.\textsuperscript{189} In each case the underlying property is legally owned by the first Intermediary (i.e. the Intermediary having a direct link with the issuer, at one remove from the Investor.)\textsuperscript{190}

If legal title to the underlying property is with the first Intermediary, and if that title is held by the first Intermediary for the second Intermediary, which in turn holds for the Investor, the

\textsuperscript{188} Broadly speaking, the underlying property is the global note. However the position is less simple than that with Immobilised Securities because the rights represented by the global may in certain circumstances be replaced by rights under other documents, namely definitives and the deed of covenant. Together, the global, the definitives (if any are in issue) and the deed of covenant create a network of contingent and mutually dependent rights, and identifying the exact legal nature of the global (i.e. of the underlying property) is not straightforward. However, for the purpose of this discussion the analysis of the legal nature of the global will be limited to those aspects of the network that are most important.

In the case of permanent global bonds, the underlying property comprises the covenant of the issuer to pay principal and interest to the holder of the global, together with the right of the holder of the global to exchange the global for definitives upon the default of the issuer. In the case of temporary global bonds, the underlying property comprises the right of the holder to exchange the global for definitives, together with the right to receive principal and interest if the issuer defaults in its obligation to issue definitives. In cases where a deed of covenant is executed, the Disappearing Global provision, described in footnote II above, does not affect the analysis of the underlying property as it is merely a contingency, occurring only on default.

\textsuperscript{189} In the case of Immobilised Securities, these are the clearer and its depository. In the case of Global Securities, they are the clearer and its common depository.

\textsuperscript{190} This is because, in the case of Immobilised Securities, the underlying property consists of negotiable instruments. The first Intermediary has possession and therefore legal title, which follows possession. Global Securities are expressed to be in bearer form; the underlying property is therefore legally owned by its holder, the first Intermediary.
The true legal nature of the custodial relationship is a complex question, which will be considered in detail in chapter 4 below. For the sake of brevity here that chapter's conclusions will be summarised as follows. As legal title is with the first Intermediary, the Investor's interest cannot also be in the nature of legal title. The only form of ownership that English law can confer on a person who does not have legal title to assets is equitable title. If the Investor has a proprietary interest\(^{191}\) in the underlying property, it can only be equitable, because it is indirect. The separation of equitable and legal title creates a trust\(^{192}\), of which the first Intermediary is the trustee. The beneficiary is the person for whom the first Intermediary directly holds the Underlying Property, i.e. the second Intermediary. If the interest of the second Intermediary is an equitable interest under a trust, the only manner in which a proprietary interest can be conferred on the Investor is under a sub-trust.\(^{193}\)

This is the position under English law. Of course, the relationship between the second Intermediary and the Investor is not governed by English law, but by the governing law of the General Terms and Conditions of the clearers.\(^{194}\) These jurisdictions do not recognise trusts in their domestic law. However, as chapter 7 will discuss, these jurisdictions have passed legislation in support of their clearing system which has the result of protecting the interests

\(^{191}\) Another alternative is that the investor's rights are not proprietary but merely contractual. Contractual rights attract the insolvency risk of the Intermediary, while proprietary rights do not. The commercial expectation (reflected in the regulatory capital treatment of Intermediate Securities) is that the investor does not take the credit risk of the Intermediaries, and therefore that its rights are proprietary. It will be argued in chapter 5 below that this expectation probably is correct.

\(^{192}\) An alternative view, namely that arrangements of this type give rise, to bailment, is discussed in chapter 4 below.

\(^{193}\) Under Grainge v Wilberforce (1889) 5 TLR 436, which will be discussed in detail below, the law “looks through” bare sub-trusts, so that where A holds property on trust for B, who holds the property on bare sub-trust for C, A is deemed to hold the property directly for C and B drops out of the picture. However, this principle will not apply here as the second Intermediary (the clearer) is not a bare sub-trustee as it has active duties under its general terms and conditions in relation to the administration of the assets.

\(^{194}\) (Belgian law for Euroclear and Luxembourg law for Cedel).
of Investors under an arrangement akin to a trust, and (as that chapter will argue) the analysis under English private international law is to recognise these arrangements as if they were trusts, because of the wide terms of the Recognition of Trusts Act 1987 which implements the Hague Convention.195196

(ii) Unallocated

Intermediate Securities are generally unallocated.197


In analysing the relationship between the first and second Intermediaries as a trust, the following distinction should be made. In many bond issues a trustee is appointed by trust deed to represent the bondholders from time to time. Such an appointment used to be traditional in England; it was preferred to the appointment of a fiscal agent as is customary in US bond issues. The trust discussed above of which the first Intermediary is the trustee ("the Intermediary Trust") is different from the trust which is created expressly by a trust deed. Where a trust deed is executed, the trust property is not the Underlying Property, but rights which are additional to and exist in parallel to the underlying property. In the trust deed, the issuer covenants directly with the trustee to pay interest and principal, and the trustee may enforce this covenant directly on behalf of bondholders. It is also provided in the trust deed that the rights to principal and interest comprised in the underlying property will not be enforced by the holder, and that the trustee has the exclusive right of enforcement. This provision binds the holder (the first Intermediary) as the underlying property is expressed to be issued subject to the trust deed. Accordingly, where trustees are appointed in respect of Intermediate Securities, two parallel trusts arise, one express (under the trust deed) and one by operation of law (the Intermediary Trust).

196 The reasons for this arrangement, whereby the issuer gives two parallel covenants, are clear from the case of In re Uruguay Central and Hyguerital Railway Company of Montevideo (1879) 11 CD 278, which concerned a bond issue in which the obligation of the company to pay principal and interest to holders of the bonds was expressed as a covenant of the company to the trustee, and was not undertaken by the company directly to the holders. The company fell into arrears in interest payments and 6 bond holders presented a petition for its winding up. The petition was dismissed inter alia because holders were not creditors of the company under s. 91 of the Companies Act 1862, their rights of action being through the trustee only. per Jessel, M. R. at 380, 381: "There can be no question that upon that deed the holders of the bonds are not creditors; they are merely cestuis que trust of a charge, having a right, no doubt, to put their trustees in motion to compel payment under the covenant, but not having any independent right to sue the company at law or in equity."

197 In the case of Immobilised Securities, the underlying property comprises definitive bonds that are issued with distinctive numbers. (In the case of bonds which are London listed the rules of the London Stock Exchange require definitive bonds to be issued with serial numbers: section 13.22 e of the Stock Exchange's Listing Rules and distinguishable from one another.) Therefore particular Physical Securities forming part of the underlying property could in theory be allocated to particular Immobilised Securities. In practice however particular underlying bonds are not in general earmarked for particular accounts at Euroclear or Cedel. All securities accounts at Euroclear are fungible. While Cedel offers both fungible and non-fungible accounts, only a very small minority of securities are held on a non-fungible bases.) Thus, the interest of the Investor is pooled with the interests of all other Investors in Immobilised Securities of the same issue, at the level of the second Intermediary (the clearer). (There is no pooling at the level of the first Intermediary, the local depository, because all the underlying property is held for the second intermediary, and there is therefore no pooling of the second Intermediary’s interest with the interests of third parties.)
The legal consequences of commingling the assets of different persons is a complex subject, which chapter 5 below will examine in detail. While in certain circumstances unallocated arrangements with an intermediary can effectively render the rights of Investors merely contractual as against the intermediary, in the case of Immobilised and Global Securities the Investors' rights are proprietary, on the basis of the analysis that will be developed in chapter 5.

If the Investor's right is unallocated, the only way that it can be a proprietary right attaching to the underlying property is by way of co-ownership with all the other Investors in the same issue. Because the underlying Property is unallocated, it is co-owned. 198

English law recognises two forms of co-ownership: joint tenancy and tenancy in common. Both terms derive originally from land law but can apply equally to the co-ownership of personal property. The difference between joint tenancy and tenancy in common lies in the four unities. 199

In the case of Global Securities, the position is slightly different because the Investor's interest is not merely unallocated, but also incapable of allocation, for the simple reason that there are no underlying definitives that could be earmarked for particular Investors. The underlying property consists of a global note representing the entire issue of bonds. The fractional parts of the global equating to individual definitives do not have distinctive numbers and are not otherwise distinguishable one from the other.

The first Intermediary holds the global for the two second Intermediaries, Euroclear and Cedel. Thus, in the absence of allocation, the interests of the two second Intermediaries are pooled with each other at the level of the first Intermediary. As with Immobilised Securities, the interests of Investors are also pooled at the level of the second Intermediaries.

Thus, in the case of Immobilised Securities, there will be commingling in the jurisdiction of the second intermediaries (Belgium and Luxembourg); in the case of Global Securities, there will be commingling in the jurisdiction of the first Intermediary (England) and also in those of the second Intermediaries (Belgium and Luxembourg) in circumstances where allocation would not have been possible because the different parts of the underlying property have no inherent identity.

198 *See Re Goldcorp Exchange Ltd* [1994] 3 WLR 199. This idea will be developed in chapter 5.

199 "The four unities of joint tenancy which must exist, or the tenancy will be in common, are:

(1) Possession...
(2) Interest...
(3) Title...
(4) Time..."
In other words, in order for a joint tenancy to be established, each co-owner must be entitled to possession of the whole of the co-owned property, have the same quantum of interest in it, have title by the same instrument and have the interest for the same interval of time. The unities will in practice not be present in Intermediate Securities, which are therefore co-owned by Investors under a tenancy in common.

Intermediate Securities are therefore interests under equitable tenancies in common. In their legal nature, Intermediate Securities are akin to unit trusts.  

5. The Benefits of Negotiability

To recap, it has been argued that Intermediate Securities are not negotiable instruments, and are interests under equitable tenancies in common. The benefits of negotiability are ease and integrity of secondary market transactions. It is argued (in sections 6 and 7 below) that such benefits may also be enjoyed by Intermediate Securities, if not under the law merchant, then under other branches of law including the law of equity.

6. Ease of Secondary Market Transactions

The old common law rule was that choses in action were not assignable, because of a policy against maintenance. An exception was evolved by the law merchant from the medieval period onwards in favour of negotiable instruments. Then, in 1873 a statutory exception was created, which was


200 The capital value of a unit trust is variable because units are redeemable as well as transferable. Immobilised Securities and temporary Global Securities are comparable because the investor can remove his interest from the arrangement (by requiring physical delivery in the case of Immobilised Securities, or by calling for definitives in the case of temporary globals). Permanent Global Securities differ in that the interest of the investor can be transferred to another investor, but cannot be removed from the equitable tenancy in common.

201 The adverse tax consequences of unit trust status are avoided for the reasons discussed in section B.9 below.

201 Indeed, the original meaning of negotiable was, transferable.
later replaced by s136 of the law of Property Act 1925. This permits the legal assignment of choses in action provided certain formalities and restrictions are observed. These are (broadly) that:-

- the assignment is absolute;
- the assignment is in writing; and
- written notice of the assignment is given to the obligor.

Compliance with the last two items would be inconvenient in the secondary markets, and hence part of the concern to preserve negotiable status.

The law of equity has long recognised assignments of choses in action. Because equity and the common law are separate branches of law it is not necessary to identify an exception to the old common law rule to permit a chose in action to be assigned in equity, and accordingly neither negotiable status nor compliance with section 136 are necessary.

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202 Under the Supreme Court Judicature Act 1987, s25(6) (repealed).

203 "136 (1) Any absolute assignment by writing under the hand of the assignor (nor purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, is effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice -

(a) the legal right to such debt or thing in action; and
(b) all legal and other remedies for the same; and
(c) the power to give a good discharge for the same without the concurrence of the assignor..."

204 The statutory regimes for the transfer of registered securities are currently provided by the Stock Transfer Act 1963 in the case of physical equities and gilts, the Stock Transfer Act 1982 in the case of dematerialised gilts and the Companies Act 1989 in the case of dematerialised corporate securities.

205 In particular, the need for the assignment to be in writing would be problematic. Secondary market transactions in Computerised Bearer Securities, like the securities themselves, are characteristically electronic, with no written instrument of transfer. Written contract notes or other confirmations may be issued, but these are merely in the nature of records. If it is not legally possible to effect secondary market transactions in Computerised Bearer Securities electronically (with the result that purported electronic transfers take effect in contract only) this would clearly pose a major problem in practice.

206 In theory, the Uncertificated Securities Regulations 1996 which form the basis for CREST may also be used to permit electronic transfers in the euro bond markets, as the regulations are not limited to the CREST system.
It was argued above (in Chapter 3 section 4) that Intermediate Securities²⁰⁷ are not legal but equitable. Equitable property cannot be legally transferred²⁰⁸. Any assignment of an Intermediate Security must therefore be an equitable assignment.

While this obviates the need for compliance with section 136, it raises other problems. Section 53(1)(c) of the Law of Property Act 1925 provides as follows:

"a disposition of an equitable interest or trust subsisting at the time of the disposition, must be in writing signed by the person disposing of the same, or by his agent hereunto lawfully authorised in writing or by will."²⁰⁹

The effect of a purported equitable assignment that does not comply with this section will be to confer on the assignee merely contractual rights, leaving it vulnerable to the vendor's insolvency²¹⁰ or double dealing.²¹¹

²⁰⁷ The Term "Intermediate Securities" is defined in Chapter 3 section 4 to mean intermediate Computerised Securities.

²⁰⁸ Because the common law cannot recognise the transfer of property which it does not in turn recognise.

²⁰⁹ The section replaced section 9 of the Statute of Frauds (1677) (repealed), which provided as follows: "all grants and assignments of any trust or confidence shall likewise be in writing, signed by the party granting or assigning the same, or by such last will or devise, or else shall likewise be utterly void and of none effect".

²¹⁰ Upon the purported assignor's insolvency, the purported assignee would be merely an unsecured creditor. If the purported assignor went on fraudulently to dispose of the securities to a third party under an assignment complying with section 53(1)(c), then provided the third party had no notice of the fraud, it would take the securities free of any interest of the purported assignee.

²¹¹ Legal commentators customarily identify the following disadvantages of equitable (as opposed to legal) assignment, in addition to section 53(1)(c):

(i) the risk that the assignor may subsequently dispose of the assigned asset under a legal assignment to a bona fide third party without notice of the prior equitable assignment, the legal assignee taking priority over the equitable assignee ("the priority disadvantage");

(ii) the risk that the assignee may owe moneys to the issuer, which may be set off by the issuer against the payment obligation under the assigned instrument ("the set off disadvantage"); and

(iii) the disadvantage that an equitable assignee cannot sue the issuer in its own name, but must join the assignor ("the enforcement disadvantage").
As indicated above, in an electronic environment, it would be impracticable to obtain the signature of the assignor. Contract notes and other confirmations may be issued in writing, but these are in the nature of records and not dispositions. It would therefore be desirable to show that section 53(1)(c) does not apply. Four alternative arguments to this effect are available, based in turn on the doctrine of equitable estoppel, the rules relating to bare sub-trusts, the view that no disposition is involved in secondary market transactions in Intermediate Securities, and finally, the principles of English private international law.

a. Equitable estoppel

One approach to overcoming the problem of section 53(1)(c) is to rely on the doctrine of estoppel. It would be unconscionable for a vendor, who has sold Intermediate Securities to a purchaser and received consideration, to argue that, because the requirements of section 53(1)(c) have not been satisfied, the purchaser does not own the Intermediate Securities. Equity will not permit statute to be used as an instrument of fraud, and upon receipt of the purchase price, equity would estop the vendor from denying the title of the purchaser on the basis of section 53(1)(c).

However, these are relative disadvantages of equitable as opposed to legal assignment, and arise in respect of equitable assignments of property which is capable of both legal and equitable transfer. We saw that Intermediate Securities are equitable and therefore incapable of legal transfer. The analysis is therefore different. The priority disadvantage cannot arise if there can be no such thing as a legal transferee. The set off disadvantage cannot arise because the only legal owner of the Intermediate Securities is the first Intermediary, and the issuer is on notice that the first Intermediary does not own the Intermediate Securities beneficially, and would therefore not be entitled to set off. The enforcement disadvantage does not apply to Immobilised Securities. The assignee need not join any assignor if it wishes to sue the issuer. It may need to join an intermediary, but this is not an incident of equitable transfer, but due to intermediation. (It was also shown that, in the case of Global Securities where no trust deed is executed, the investor will be able to sue the issuer directly in its own name, under the deed of covenant.) Further, under the rules of private international law, the Enforcement disadvantage may not apply were the proper law of the assigned property is not English law: see Mark Moshinsky The Assignment of Debts in the Conflict of Laws, (1992) L 109 QR, 591.


213 Equitable estoppel in the context of section 53(1)(c) is discussed by Denning MR in Re Vandervell's Trusts (No 2) [1974] 3 All ER 205 at 213: "... there was an equitable estoppel. His conduct was such that it would be quite inequitable for him to be allowed to enforce his strict rights (under a resulting trust) having regard to the dealings which had taken place between the parties: Hughes v Metropolitan Railway Co (1877) All Cas 439 at 448."
In the event of the vendor's insolvency, this estoppel would be effective against the vendor's liquidator. 215

However, this estoppel only operates against the vendor. It would not affect third parties, so that if the vendor fraudulently disposed of the same securities to a bona fide third party, perfecting that disposal in writing, then provided the third party did not have notice of the prior transaction, it would take the securities free of the interest of the original purchaser, who would be left as an unsecured creditor of the vendor. Estoppel is therefore not an answer to section 53(1)(c). 216

b. **Bare sub trust**

Another approach is the "bare sub trust" argument. This is as follows. In the securities markets, as in certain others, it is customary for the conclusion of the contract of sale, and the delivery of property pursuant to that contract, to take place on different dates. The interval between contract and delivery is called the settlement interval. It has long been established that, during the settlement interval, the vendor holds the purchased property on trust for the purchaser, under a constructive trust, provided the contract is specifically enforceable (and provided also that the purchased property is allocated to the bargain). "So long as the vendor enters into a specifically enforceable contract for the sale of property he becomes a constructive trustee thereof for the purchaser until the contract is completed by the transfer of the property to the purchaser or to the order of the purchaser." 217

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214 This produces a result similar to, but not identical with, the constructive vendor-purchaser trust discussed below. Unlike constructive trust, equitable estoppel does not confer equitable title on the purchaser, but rather prevents the vendor from denying it. See Waltons Stores Interstate Ltd. v Maher (1988) 62 A.L.J.R. 110, per Brennan J at 125.

215 because the liquidator stands in the shoes of the insolvent company. See Goode, Commercial Law, p 850.

216 Although it does not address fraud risk, it does address insolvency risk, for the estoppel would bind the liquidator of the vendor. See the persuasive authority of In re Sharpe [1980] 1 WLR 219.

It is clear that a vendor-purchaser trust arises upon agreements for the sale of shares in a private company.\footnote{See \textit{Oughtred v IRC} [1958] 1 All ER 252} However an agreement for the sale of securities in the secondary markets is probable not specifically enforceable.\footnote{This is because specific performance is a discretionary remedy, which will not be granted in cases where damages would be an adequate remedy for the breach of the agreement for which specific performance is sought. As securities could be purchased from a third party in the market, damages would be an adequate remedy for a contract of this kind.}

Nevertheless, there is authority that the payment of the purchase price will give rise to a vendor-purchaser trust even where the contract is not specifically enforceable. Where the purchase price under a bargain is paid before the completion of the bargain by the delivery of the securities to the purchaser, the vendor holds the securities on trust for the purchaser. "Once the purchaser has wholly fulfilled his side of the contract (eg by paying over the purchase price) but the vendor still has title to the property then the vendor holds the property on a bare trust for the absolutely entitled purchaser."\footnote{Underhill and Hayton, op. cit., Article 36.} This principle is illustrated in the case of \textit{Chinn v Collins} \footnote{(H.L.) [1981] A.C. 533} in which the discussion by Lord Wilberforce of a vendor-purchaser trust arising upon an agreement for sale and payment of purchase price, indicates that compliance with section 53(1)(c) is unnecessary.\footnote{"Then the respondent contended that, granted the identity of the shares...he could not be regarded as a beneficiary in respect of them because he could not get specific performance of the agreement.... But in my opinion the whole contention is misconceived. The legal title to the shares was at all times vested in a nominee for [the trustees] and dealings related to the equitable interest in these required no formality. As soon as there was an agreement for their sale accompanied or followed by payment of the price, the equitable title passed at once to the purchaser, ...and all that was needed to perfect his title was notice to the trustees or the nominee, which notice both had at all material times." (at 548). See also \textit{Holroyd v Marshall} (1862) 10 HL Cas 191 in which Lord Chelmsford discusses the principle of a vendor-purchaser trust without linking the principle with the availability of specific performance and Dixon J in \textit{Palette Shoes v Krohn} (1937): "Because value has been given on the one side, the conscience of the other party is bound when the subject comes into existence, that is, when, as is generally the case, the legal property vests in him. Because his conscience is bound in respect of a subject of property, equity fastens upon the property itself and makes him a trustee of the legal rights of ownership for the assignee."}
An acknowledged objective of the securities markets is delivery versus payment ("DVP"), or the synchronisation of the delivery of securities and the payment of their purchase price in the settlement of bargains. This is in order to reduce counterparty risk, or the risk for either party (party A) that the other party (party B) will fail to deliver or pay in circumstances where party A has delivered or paid and is therefore unable to withhold delivery or payment to limit the damage of party B's breach of contract. However, for operational reasons, true DVP remains in many cases something of a holy grail. Delivery may precede payment, and payment may precede delivery.

In cases where payment precedes delivery (even by a short interval) the legal position of the vendor is as follows. During the first part of the settlement interval (after the bargain but before payment) it continues to own the securities beneficially. During the second part of the settlement interval (after payment but before delivery) it holds the securities as bare trustee for the purchaser.

It has been noted that the interest of the Investor in Computerised Securities is itself an equitable interest under a sub-trust. The vendor-purchaser trust must therefore be in the nature of a sub-sub-trust. During the second part of the settlement interval, therefore, the Computerised Securities are held on bare constructive sub-sub-trust by the vendor for the purchaser.

It is established that the law "looks through" bare sub-trusts (as opposed to sub-trusts where the trustee has active duties). The position of a bare trustee (Mr Moody) was considered in the case of *Re Lashmar*. It appears to me that the true way to regard this will is to look through

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223 See G30 Recommendation 5: "Delivery versus payment (DVP) should be employed as the method for settling all securities transactions."

224 see Chapter 3 section 4.b.i above.

225 *Re Lashmar: Moody v Penfold* 64 LT 333, CA.
Moody as nobody."  

The effect of "looking through" a bare sub-trustee is that, where A holds property on trust for B, and B in turn holds his interest in the property as bare sub-trustee for C, A is deemed to hold the property on a direct trust for C. In *Grainge v Wilberforce* it was stated that "The case, therefore, fell within the principle that where A was trustee for B, who was trustee for C, A held in trust for C, and must convey as C directed."

Applied to secondary market transactions in Computerised Securities, these principles produce the following result. The second Intermediary (i.e. the clearing system) (A) holds the underlying property on sub-trust for the Investor (B). B concludes a bargain for the sale of the securities to C. The purchase price is paid before the securities are delivered. When payment is made, B holds his interest on a bare constructive sub-sub-trust for C under the principle in *Chinn v Collins* ("the first stage"). Thereupon, A is deemed to hold the underlying property on a direct sub-trust in favour of C under the principle in *Grainge v Wilberforce* ("the second stage"). C now owns the Computerised Securities by operation of law, even in advance of the time when A's database is amended in his favour.

It is submitted that section 53(1)(c) does not apply to this transaction. The first stage escapes by virtue of section 53(2), which provides:

"(2) This section does not affect the creation or operation of resulting, implied or constructive trusts."  

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226 per Lindley, L.J. at 335. And again, "...it appears to me, therefore, that there is no active trust, no active duty whatever to be performed by the trustees...I think, therefore, that no estate remained in the trustee." per Fry, L.J. at 336.

227 (1889) 5 TLR 436

228 by Chitty J, at 437.

229 See also *Grey v IRC* [1958] 1 All ER 246 per Upjohn J at 250; revsd CA [1958] 2 All ER 428 at 433 per Lord Evershed MR.

230 An example of this analysis being applied is found in *Oughtred v IRC* per Lord Radcliffe (dissenting) at 625: "On June 18, 1956, the son owned an equitable reversionary interest in the settled shares; by his oral agreement of that date he created in his mother an equitable interest in his reversion, since the subject-matter of the agreement was property of which specific performance would normally be decreed by the court. He thus
The second stage escapes by virtue of the same section. There are a limited number of ways in which a trust can arise: by statute, by the intentional act of the parties, and by operation of law. Trusts arising in the last manner are called implied trusts. The trust in favour of C created by the second state is neither statutory nor express, but arises by operation of law and is therefore implied. Section 53(1)(c) does not apply to implied trusts by virtue of section 53(2)232.

Therefore, if payment precedes delivery, section 53(1)(c) will not apply to secondary market transaction of Intermediate Securities. Of course, to the extent that payment precedes delivery, the purchaser takes the credit risk of the vendor. The answer to this problem may be that the interval between payment and delivery need, for the purpose of disapplying 53(1)(c), be only a scintilla of time. Since settlement in these markets is generally effected, not directly between the parties to a transaction, but through correspondent banks and custodians or other intermediaries who require to receive payment or delivery instructions a certain "lead time" before they are able to implement them, the risk that the vendor may reverse a delivery or payment instruction during the scintilla of time which begins when the purchase price is received and ends when the securities are due to be delivered, may be sufficiently remote to be discountable. However, it is understood that in practice, delivery often precedes payment, which often takes place on a gross basis at the end of the business day.

c. No disposition

became a trustee for of that interest sub modo; having regard to sub-s (2) of s. 53 of the Law of Property Act, 1925, sub-s (1) of that section did not operate to prevent that trusteeship arising by operation of law."

231 It is probably constructive rather than resulting.

232 This view might appear to conflict with the decision in Grey v IRC, discussed above. Referring to this case as authority, David Hayton writes: It is vital to appreciate that A's direction to T to hold the property for B, instead of A, amounts to a disposing of his subsisting equitable interest to B within section 53(1)(c)." (Hayton and Marshall: Cases and Commentary on the Law of Trusts, p. 55). However, the conflict is more apparent than real, for the following reason. In Grey, the transaction which failed because of section 53(1)(c) was an attempt to create an express trust (ie the oral direction of the settlor to the trustees). In the above analysis, the transactions which escape the terms of section 53(1)(c) are both implied trusts. See also Neville v Wilson [1996] 3 All ER 171.
(i) *original promise*

The third possible argument is that there is no disposition. Earlier this chapter referred, loosely, to the transfer of negotiable instruments. However, it has long been argued that bearer securities are not transferable. "The note is an original promise by the maker to pay any person who shall become the bearer; it is therefore payable to any person who successively holds the note *bona fide*, not by virtue of any assignment of the promise, by an *original and direct promise moving from the maker to the bearer*. The implication of this argument is that secondary market transactions in such instruments are not dispositions.

The original promise argument applies to Physical Securities. However, it is uncertain whether it applies to Intermediate Securities. The Investor is not the bearer of the Underlying Property, and therefore the value of Intermediate Securities cannot be based on an original and direct promise moving from the maker to the bearer.

In order to argue that secondary market transactions in Intermediate Securities are not dispositions, one must look at the nature of such transactions. When A, an Investor, sells his Intermediate Securities to B, what is the process whereby the clearer (the second Intermediary) ceases to hold its interest in respect of the underlying property for A, and begins to hold it for B?

(ii) *trust in favour of a class*

It was argued (in Chapter 3 section 4.b.i above) that the civil law relationship between the clearer acting as second Intermediary and investors would be recognised under English private international law as if it were a trust.
This quasi trust (arising under local Decrees)\textsuperscript{234} is not expressed to be in favour of individually identified Investors but in favour of Investors as a class, the composition of that class being ascertainable from time to time by reference to the records of the clearer. Secondary market activity in Intermediate Securities is settled by changes in the identity of the members of a class.\textsuperscript{235} Property remains at all times with the class. If an individual leaves the class, it loses its interest under the trust, not because of its individual identity, but because of the loss of class membership. Similarly, if an individual joins the class, it gains an interest under the trust, not because of its individual identity, but because of its class membership. Property is an incident of class membership, and for this purpose, class membership confers status distinct from individual identity.

Such status does not of course amount to separate legal personality (permitting property to be \textit{legally} owned by the class), and therefore the class cannot be said to be corporate. However, the class has a status sufficient for the \textit{equitable} ownership of property. It may therefore be described as "quasi-corporate", in the sense that it enjoys equitable proprietary rights independently of the separate personalities of the members of the class from time to time.

A secondary market transaction has the effect of altering the database of the clearer, but not the terms of the trust. When a secondary market transaction is settled, the Intermediary ceases to hold for A and starts to hold for B, because A has left and B has joined the category of persons for whom its interest in the securities held. B becomes a beneficiary, and beneficially owns the

\textsuperscript{234} Belgian Royal Decree No. 62 of November 1967 and Luxembourg Grand Ducal Decree of February 1971.

\textsuperscript{235} The composition of the class is determined by the clearer's database which is akin to a register of bondholders, in that the identities and holdings of investors are determined by reference to it by time to time. (For this reason, while the Underlying Property consists of or relates to bearer securities, Intermediate Securities are a species of registered security.)
securities, under an original and direct trust moving from the trustee to the beneficiaries from time to time.\textsuperscript{236}

By analogy, if A declares a trust in favour of the spouses of his siblings from time to time, and if A's brother divorces Mary and marries Sarah, Mary cannot be said to have disposed of her interest under the trust to Sarah.\textsuperscript{237} Could it therefore be argued that secondary market transactions in Intermediate Securities are not dispositions for the purposes of section 53(1)(c)? It is necessary first to examine the meaning of the term 'disposition'.

(iii) "disposition"

Section 205(1)(ii) of the Law of Property Act 1925 includes the following provision:

"... 'disposition' includes a conveyance and also a devise, bequest, or an appointment of property contained in a will...".

The meaning of the term in the context of section 53(1)(c) is considered at some length in Grey v Inland Revenue Commissioners\textsuperscript{238}.

\textsuperscript{236} The basis of B's entitlement is the entry of its name in this database. Although there may be a contractual document in which A agreed to sell its interest in the Intermediate Securities to B, this document is not the basis of B's title: it merely imposes contractual obligations on A to procure that its name is replaced by that of B on the database. It is a contract and not a conveyance.

\textsuperscript{237} Terrence Prime advances a similar argument in connection with the express trust arising where a trust deed is executed: see International Bonds and Certificates of Deposit, p. 243.

\textsuperscript{238} [1959] 3 All E.R. 603. In this case, a settlor transferred shares to trustees to hold as his nominees. The settlor later orally directed the trustees to hold the shares on various trusts for his grandchildren. Declarations of trust were subsequently executed as deeds by the settlor and the trustees in favour of the grandchildren. On the question whether the deeds were chargeable with ad valorem stamp duty as voluntary dispositions, it was held that they were so chargeable because the earlier parole directions were not effective because of section 53(1)(c).

"My Lords, if there is nothing more in this appeal that the short question whether the oral direction that Mr. Hunter gave to his trustees on Feb. 18, 1955, amounted in any ordinary sense of the words to a 'disposition of an equitable interest or trust subsisting at the time of the disposition', I do not feel any doubt as to my answer. I think that it did. Whether we describe what happened in technical or in more general terms, the full equitable interest in the eighteen thousand shares concerned, which at that time was his, was (subject to any statutory invalidity) diverted by his direction from his ownership into the beneficial ownership of the various equitable owners, present and future, entitled under his six existing settlements." per Lord Radcliffe at 607.
"If the word "disposition" is given its natural meaning, it cannot, I think, be denied that a direction given by Mr. Hunter whereby the beneficial interest in the shares theretofore vested in him became vested in another or others is a disposition."\textsuperscript{239}

It had been argued that the meaning of the term 'disposition' for the purposes of the section is limited to sense of 'grants and assignments'\textsuperscript{240}, but this argument failed.\textsuperscript{241}

While this narrow interpretation of the word was rejected, the judgment also indicates the criterion which delimits the term. The transaction under consideration was a disposition because it "diverted", "displace[d]" and caused Mr Hunter's equitable interest to become "vested in another...".

It was shown above (in chapter 2) that an equitable interest is a type of property, and that property may be loosely considered as a legal relationship between a person and an asset. The case indicates that a disposition consists of dissolving the relationship of an asset with one person (or class of persons) and forming a new relationship between the asset and another person (or class of persons).\textsuperscript{242}

In cases where the proprietary relationship is between an asset and a class of persons who are identified for the purpose of that relationship by membership of that class and not individually, one

\textsuperscript{239} Per Viscount Simonds at 506.

\textsuperscript{240} On the basis that the Law of Property Act 1925 was a consolidating act, and did not alter the effect of section 9 of the Statute of Frauds, which applied to grants and assignments.

\textsuperscript{241} On the basis that the Statute of Frauds had been amended by the Law of Property (Amendment) Act 1924, which contained amending provisions in section 3 and schedule 3 which was duplicated in the consolidating act of 1925.

\textsuperscript{242} There is also authority that the dissolving of one proprietary relationship, without the forming of a new one in respect of the same asset, can be a disposal. 'The word 'disposition', taken by itself, and using it in its most extended meaning, is no doubt wide enough to include the act of extinguishment Re Leven (Earl)(Decd), Inland Revenue Comrs v Williams Deacon's Bank Ltd [1954] 3 All ER 81, at 85, per Wynn-Parry J; "I think that a surrender is clearly a disposition", Inland Revenue Comrs v Buchanon [1957] 2 All ER 400 at 402, CA, per Lord Goddard CJ.
may argue that changes in the membership of the class do not affect the original proprietary relationship and are therefore not dispositions. A change in class membership is not a disposition, but a form of devolution. 243

Where the owning class has corporate status, the above analysis is uncontroversial. When a shareholder in an incorporated company disposes of his shares, there is not also a pro tanto disposition of the assets of the company. This is because a corporation has legal personality distinct from the individual identity of its membership, 244 and the ownership of the underlying assets is not affected by changes in the membership of the company. Of course, although the issuers of Computerised Securities are often corporate, the bondholders are not their members, and the bond issues themselves are not corporate. Does the "no disposal" argument survive the lack of corporate status? It becomes arguable that it does, when one looks at the law relating to unincorporated associations.

(iv) unincorporated associations

It was argued above that Intermediate Securities are interests under trusts, the beneficiaries of whom are the Investors from time to time. In this respect they are comparable to certain unincorporated

243 The transaction or act of the parties is the change of membership; the new member’s new ownership of the property in place of the old member, is not the transaction, but its juridical consequence. Property “passes” by operation of law, and not by the act of the parties. It is not disposition, but devolution. The distinction between these terms is clear in the law of succession. Where property vests in a person by virtue of his status and not his individual identity as party to a transaction, his acquisition of the property upon acquiring that status is devolution (by operation of law) and not disposition (by act of the parties). The distinction is made in section 2 of the Succession Duty Act 1853; see Northumberland v. A. G. [1905]; Earl of Setland v. Lord Advocate 3 App Cas 505; and Braybrooke v. A. G. 11 ER 685.

244 “A corporation may be defined as a body of persons (in the case of a corporation aggregate)…which is recognised by the law as having a personality which is distinct from the separate personalities of the members of the body…from time to time…” Blackstone compares corporate personality to river which continues the same although waters ever change (borrowing an image from Heraclitus). I Commentaries, 469 (1765-1769)
associations. These have been defined as "two or more persons bound together for one or more common purposes, not being business purposes, by mutual undertakings each having mutual duties and obligations, in an organisations which has rules which identify in whom control of it and its funds rest and on what terms and which can be joined or left at will. The bond of union between the members of an unincorporated association has to be contractual." Conservative and Unionist Central Office v Burrell [1982] 2 All ER 1, per Lawton LJ at 4. Of course, Intermediate Securities are not unincorporated associations because they are not associations.


247 In the case of registered friendly societies, there is a statutory provision. "All property belonging to a registered society, whether acquired before or after the society is registered, shall vest in the trustees for the time being of the society, for the use and benefit of the society and the members thereof, and of all persons claiming through the members according to the rules of the society." Section 54(1)) of the Friendly Societies Act 1974.


249 See Neville Estates Ltd v Madden [1962] 1 Ch 832, per Cross J at 849, in the context of considering the ways in which a gift to an unincorporated association may take effect. The holding of the property of an unincorporated association on trust is facilitated by the Perpetuities and Accumulations Act 1964 (see below).

"While the expendable assets for the time being of a members' club are usually in the physical control of its officers or servants...those assets, as well as immovable and other types of durable property, require, in the case of such a club, to be vested in some legal person - often two or three trustees - who will hold the legal title in a fiduciary capacity for the use and benefit of the club and its members." J.F. Josling and L. Alexander, Law of Clubs, 6ed, Longman, London 1987, p. 6. See also Re Bucks Constabulary (No 2), [1979] 1 All ER 623 per Walton J at 626: "If a number of persons associate together, for whatever purpose, if that purpose is one which involves the acquisition of cash or property of any magnitude, then, for practical purposes, some one or more persons have to act in the capacity of treasurers or holders of the property. In any sophisticated association there will accordingly by one or more trustees in whom the property which is acquired by the association will be vested. These trustees will of course not hold such property on their own behalf. Usually there will be a committee of some description which will run the affairs of the association...and the normal course of events will be that the trustee, if there is a formal trustee, will declare that he holds the property of the association in his hands on trust to deal with it as directed by the committee. If the trust deed is a shade more sophisticated it may add that the trustee holds the assets on trust for the members in accordance with the rules of the association. Now in all such cases it appears to me quite clear that, unless under the rules governing the association the property thereof has been wholly devoted to charity, or unless and to the extent
There is a large body of case law concerning such trusts in favour of non-commercial unincorporated associations, the membership of which varies from time to time. It is clear that at least some of these cases concern associations which permit changes of membership to take place without writing. As far as section 53(1)(c) is concerned, it might be thought that these cases would consider the section, and deal with the apparent problem that changes of membership involve the disposal of an equitable interest, and therefore require to be in writing. However, the point has never been taken. The case law "...fails to explain how the equitable interest of a member passes on his resignation without compliance with Law of Property Act 1925 s.53(1)(c)".

A satisfactory explanation may be the "quasi-corporate" analysis outlined above. Many of the cases concern a different issue, i.e. the rule against perpetuities, which arises where there is a trust in favour of a changing class of persons from time to time.

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250 For example, Carne v Long (1860) 2 De GF & J, 45 ER 550 concerned the Penzance public library. Rule 1 provided that "Subscribers of one guinea annually, being duly elected and paying one guinea entrance, shall be ordinary members." Also, Neville Estates Ltd v Madden [1961] 3 All ER 769 concerned the Catford synagogue. "By-law A read 'The members of this synagogue consist of seatholders, i.e. persons (whether male or female) who shall be in occupation of seats at this synagogue'. An applicant for membership was first interviewed by the minister. His application then went before the board of management, and if they considered him suitable the application was sent to the United Synagogue for its approval. Each member paid a subscription and forfeited his rights of membership if he failed to keep up his payments." Per Cross J at 772, 773.

251 or, before 1925, section 9 of the Statute of Frauds (1677) which it replaced.

252 Jill Martin, Hanbury & Martin, Modern Equity, 14ed, London Sweet & Maxwell, 1993, p. 368. Again, "When a member of an ordinary social club resigns his membership, how does this equitable interest in the property of the club pass to the other members without the signed writing required by this statute? This is a matter which has never been satisfactorily explained." J.H.C. Morris and W. Barton Leach, The Rule Against Perpetuities, 2ed, London Stevens & Sons, 1962, p. 315.

253 "Before the 1964 Perpetuities and Accumulations Act there were particular legal obstacles confronting gifts to unincorporated bodies. The gift could not be an absolute gift to such a body because such body has no legal personality. It could not be a valid gift if construed as a gift to the present and future members of the body because the intent to ensure benefitting future members required the capital to be kept intact and held on trust for only the income to be used, so that the capital would remain available for the benefit of future members. This rendered the gift void for infringing the rule against remoteness, though since the 1964 Act such a gift would be valid for the statutory perpetuity period." Hayton and Marshall, Cases and Commentary on the Law - 65 -
some cases the purported trust fails as a perpetuity. In such cases, there are indications that the rule against perpetuities is the only difficulty with this method of holding property. In other cases, the trusts escape the rule against perpetuities (because they are charitable, or permit the disposal of capital, so that they are not endowment trusts caught by the rule, or benefit from a statutory exception). In these cases, which confirm the validity of trusts in favour of fluctuating bodies of individuals, there is no indication that the continuing validity of such trusts depends upon written transfers of the equitable property by retiring members and in favour of new members.

This view is confirmed by the case of *Re Conveyances, Abbatt v Treasury Solicitors and others.* In this case, land was acquired by an ex-servicemen's club and held by the club's trustees. The club subsequently altered its constitution and extended its membership. The trustees sold part of the land and difficulties arose as to their ability to make a good title. On a summons to determine the question of title, it was held at first instance that the property did not belong to the present members, but only to those...

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254 For example, *In re Drummond, Ashworth v Drummond* [1914] 2 Ch 90.

255 "If the devise had been in favour of the existing members of the society, and they had been at liberty to dispose of the property as they might think fit, then it might, I think, have been a lawful disposition." *Came v Long*, per Lord Campbell L.C at paragraphs 79,80. See also *Leahy v A.G. for New South Wales* [1959] AC 457, per Simonds V.C. at 486: "No difficulty will arise if only a charitable body can be selected."

256 e.g. *Cock v Manners* (1871) L R 12 Eq 574

257 e.g. *In re Smith* [1914] 1 Ch 937; *In re Price* [1943] 1 Ch 422; *In re Drummond* [1914] 2 Ch 90; *In re Lipinski's Will Trusts* [1976] 1 Ch 235.

258 e.g. *Leahy v A.G. for New South Wales* [1959] AC 457.

259 "It is a trust for private individuals, a fluctuating body of private individuals..." *In re Drummond*, per Eve J at 97.

260 It is of course true that the issue in most of these cases was the initial validity of the trust in question. However, the fact that the point is never taken, obiter or otherwise, suggests that it may not apply.

261 [1969] 3 All ER 1175
who had been members at the date of alteration of the constitution. On appeal it was held that title vested in the trustees in trust for all the present members of the club\textsuperscript{262}. If section 53(1)(c) had applied, it would have prevented the new members from acquiring an interest, unless of course written instruments were required to be executed disposing of club property upon every change in club membership. While this is theoretically possible, it is unlikely, and nowhere indicated in the judgment. There was no indication that the requirements of section 53(1)(c) applied or required the acquisition of beneficial title by the new members to be in writing.

The implication is that there are no dispositions. This view is supported by the language of Cross J in \textit{Neville Estates Ltd v Madden}\textsuperscript{263} in his discussion of a trust in favour of an unincorporated association’s membership from time to time: "...the donors meant this fund... to be held on trust for the synagogue as a \textit{quasi-corporate entity}\textsuperscript{264} (The author’s italics). This supports the "no disposal" argument outlined above. Of course, an unincorporated association is, by definition, not a corporation. However, by the interposition of a trust between the association and its property, the owner of the property may be said to be made "quasi-corporate", so that changes in the membership of the association do not affect the identity of the owner, or involve a disposition for the purposes of section 53(1)(c).\textsuperscript{265}

\textsuperscript{262} "The property was held for the benefit of the new members just as much as the old..." per Lord Denning, M.R., at 1174.

\textsuperscript{263} [1961] 3 All ER 769.

\textsuperscript{264} at 779. The term "quasi-corporate entity" is also used in a similar context in \textit{Re Grant's Will Trust} [1979] 3 All ER 359 at 366.

\textsuperscript{265} Arguably, further support for this view is found in the following passage in Jean Warburton. \textit{Unincorporated Associations: Law and Practice}, p. 46: "Rules which are incorporated into the terms of the trust can further protect and clarify the members' rights, for example by providing that a members' interest shall cease on his ceasing to be a member. Such a clause avoids the difficulty that strictly speaking, any assignment of a member's equitable interest should be in writing." See also Underhill and Hayton, \textit{Law relating to Trusts and Trustees}, pp. 216-217
Indeed, Maitland goes so far as to argue that the customary view that club property is held on trust should give way to a frankly corporate analysis. 266

Nowadays the distinction between incorporated and unincorporated associations is taken to be fundamental, and the description of a trust as "quasi-corporate" may seem strange. However it seems less strange when one considers the history of company law. Until the statutory codification of company law in the mid-nineteenth century, the distinction between commercial associations having, and not having separate legal personality was neither simple nor clear. Section C below will discuss this in more detail.

In the eighteenth century, much business was carried on by unincorporated associations. 267 The assets of these associations were held through trustees. "Indeed, extremely rare was the eighteenth century unincorporated organization that did not make at least some use of trustees." 268 This was in order to overcome the legal obstacles to an unincorporated body holding property. 269

The exact legal status of these unincorporated bodies with

266 "I do not think that the result [of the trust analysis] is satisfactory. The "ownership in equity" that the member of the club has in land, buildings, furniture, books, etc. is of a very strange kind. ...There are some signs that in course of time we may be driven out of this theory. ...the property of the "unincorporated body" is to be taxed as if it belonged to a corporation. This is a step forward. ...The natural inclination of the members of an English club would, so I think, be to treat the case exactly as if it were a case of corporate liability." Maitland, Trust and Corporation, pp. 196, 197, 198.

267 It is true that [at the end of the eighteenth century] a considerable amount of England's business was being handled by groups that were not incorporated, but which were, as has been already said, grasping at the advantages of corporateness." A.B. Dubois, The English Business Company after the Bubble Act 1720 - 1800, Octagon Books, 1971, New York, p. 85.

268 Dubois, op. cit., p. 222.

269 "We have seen that in the middle ages the law knew many miscellaneous communities and groups which performed many miscellaneous functions - governmental, charitable, religious, and social... They assorted as badly with the new view, taught by the Roman lawyers, that only a person natural or artificial could be recognized as capable of rights and duties...It followed that these unincorporated groups were incapable of owning property; and without property the activities of a group must be very limited...The legal recognition which the common law found itself unable to give was supplied by the machinery of the equitable trust. These groups might not be able to own property, but property could be held on trust for them." Holdsworth, Volume IV, pp. 477, 478.
transferable stock was unclear, both in the commercial world and to the courts: "... it was not until many years later [than the early eighteenth century] that in dealing with unincorporated companies the Courts perceived the essential difference between partnerships and companies."

Even in the early nineteenth century, the distinction was not always clear. The legal distinction between a group of people holding property through a company, and a group of people holding property through a trust, is, as a matter of legal history, unclear. This is partly because equity has made a significant contribution to the development of company law and partly because, in the great era of unincorporated commercial associations, participants in such

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270 "Commercial men did not firmly grasp the distinction between a large partnership and a chartered company till after the passing of the Bubble Act in 1720." Holdsworth, Volume III p. 192. Again, in the late seventeen century, "...the line between corporate and unincorporated societies was generally disregarded by the projectors of companies. Bodies of persons joined together to form a society, which differed from an incorporated joint stock company in no particular, except in the absence of a charter." Holdsworth, Volume III p. 215.


272 "But the unbeschränkte Haftbarkeit of partners was still maintained. That was a thoroughly practical matter which Englishmen could thoroughly understand. Indeed from the first half of the nineteenth century we have Acts of Parliament which strongly suggest that this is the very kernel of the whole matter. All else Parliament was by this time willing to grant: for instance, active and passive Processfähigkeit, the capacity of suing and being sued as unit in the made of some secretary or treasurer. And this, I may remark in passing, tended still further to enlarge our notion of what can be done by "unincorporated companies". It was the day of half-measures. In an interesting case an American court once decided that a certain English company was a corporation, though an Act of our Parliament had expressly said that it was not." Maitland, Selected Essays, Cambridge University Press, 1936, Trust and Corporation, pp. 209, 210.

273 Notwithstanding the statutory codification of company law in from the mid nineteenth century to the present day, the role of the courts in developing the body of company law upon which statute rests is clear. (See G.M. Anderson and R.D. Tollison, The Myth of the Corporation as a Creation of the State, International Review of Law and Economics, (1983), 3, 107 - 120 and David Milman, The Courts and the Companies Acts: the Judicial Contribution to Company Law, (1990) L.M.C.L.Q., 401.) In particular, the Chancellor’s court played a major role. See also Maitland, p. 129: "...a branch of the law of trusts became a supplement for the law of corporations, and some day when English history is adequately written, one of the most interesting and curious tales that it will have to tell will be that which brings trust and corporation into intimate connection with each other.
associations kept their affairs away from the courts, due to the statutory restrictions on their activities. 274

For these reasons, the treatment of unincorporated trust arrangements as quasi-corporate has a basis in English law. 275

This approach, or the view that the interposition of a trust between investors and the underlying property forms a quasi-corporate shell or barrier between them, is reflected in case law concerning the status of shares of property companies. 276

This is further support for the argument that a change in the identity of investors holding Intermediate Securities is not a disposition.

(v) Summary

To summarise the argument, the essence of a secondary market transaction in Intermediate Securities is a change in the identity of

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274 The Bubble Act 1720 (repealed 1825). See section C below. "The unincorporated association rarely came into contact with Parliament, the courts, or the Crown officials." (Dubois, op. cit., p. 438) See also Maitland, Discussion the holding of property by clubs in Trust and Corporation, at pp. 197, 198: "But what I am concerned to remark is that, owing to the hard exterior shell provided by a trust, the inadequacy of our theories was seldom brought to the light of the day. Every now and again a court of law may have a word to say about a club, but you will find nothing about club-property in our institutional treaties." "In any event, in the period, there was a nebulous haze over exactly what the Crown officers meant by their references to "partnership". The business man was obviously the last one who wanted to see this enigma resolved." (Dubois, op. cit., p. 236.)

275 R.M. Formoy discusses the position of large unincorporated commercial associations at common law in the eighteenth century, and comments, "The difficulty to be met was to determine the attitude which was to be taken up by the law with regard to this new commercial development. It was not until after the Legislature had regulated these undertakings that the Courts perceived the point of view from which they were to be regarded, and these undertakings, instead of being treated as partnerships, were treated as quasi-corporations, a change which was facilitated by the introduction of partnerships or companies formed by deed of settlement." op. cit., p. 31.

276 The old rule was that such shares were realty. However "[The case of Bligh v Brent (1836) 2 Y & C] dealt with shares in the Chelsea Water-works Company. It was decided that they were personal property: realty held for the purpose of a trading company being in equity deemed to be in the nature of personal estate...This argument was applied in...Edward v Hall (1855), 6 De G. M. & G. 74...". R.R. Formoy, The Historical Foundations of Modern Company Law, London. Sweet & Maxwell 1923, p. 8.-importantly, Edward v Hall concerned an unincorporated company, supporting the view that the interposition of a trust between investors and the underlying property can form a quasi-corporate shell.
individuals together forming a class for whom property is held in trust. Such transactions are more in the nature of devolution than disposal. For this reason, it is arguable that secondary market transactions in Intermediate Securities are not dispositions and that therefore section 53(1)(c) of the Law of Property Act (which requires disposals to be in writing) is not applicable.

e. private international law

A simpler and more pragmatic argument can be based on private international law. As chapter 6 section [E] below will argue in detail, the approach of the Rome Convention to formality of transfer is generous. A transfer will be formally valid if (broadly) it satisfies the requirements either of the law governing the transfer or the law of the jurisdiction in which either of the parties (or any agent acting on their behalf) is situated. Thus, the restrictions of section 53(1)(c) can be avoided by routing a transaction through an agent situated in a jurisdiction with no equivalent to that section.

f. conclusions

There are four alternative arguments that section 53(1)(c) should not be a problem for the secondary markets in Intermediate Securities. The first is that the transferor is estopped from taking the point. While this argument does not protect the purchaser from the vendor's double dealing, it protects the purchaser in the vendor's insolvency. The second argument is that section 53(1)(c) is disapplied by section 53(2). However, this argument is only available where payment precedes delivery and therefore may be of limited use in practice. The third argument is that the section does not apply as there is no disposal. The fourth argument is that section 53(1)(c) may not be applicable because English law may not govern the question.

Taken together, these arguments may provide a reasonable basis for the view that section 53(1)(c) is not relevant to the secondary markets in
Intermediate Securities\textsuperscript{277}, and therefore that the absence of negotiable status is not a disadvantage for Intermediate Securities for the purpose of ease of secondary market transactions. However, in the absence of statutory clarification, a small measure of uncertainty must remain.

7. Integrity of Secondary Market Transactions

It was stated in Chapter 3 section [B.1] above that the first benefit of negotiability is ease of secondary market transactions, and that the second benefit is the integrity of those transactions (i.e. the general inability of trades to be reversed). Section 5 argued that the first benefit is probably available to non-negotiable securities. The same may be true of the second. On the basis that Intermediate Securities are not negotiable, this section will examine the position of a purchaser where the vendor does not have a good and unencumbered title.

In the case of negotiable instruments, "A bona fide transferee for value acquires a good title free of any defects in the title or defences available against the claims of any

\textsuperscript{277} Even if the "no disposition" argument fails, the courts may take a robust approach to the matter. The case of \textit{In re A.E.G. Unit Trust (Managers) Ltd. \textquotesingle s Deed. Midland Bank Executor & Trustee Co. Ltd. v A.E.G. Unit Trust Managers Ltd.} [1957] 1 Ch 415 is cited by Terrence Prime (in \textit{International Bonds and Certificates of Deposit}, Butterworths, London, 1990 p244 note 3), with the comment, "It may well be that in any case the Law of Property Act 1925 has no application to situations which are primarily commercial and where application would lead to absurdity."

In this case the trust deed of a unit trust provided that the excess of the amount of income available for distribution over the amount of income (determined by the managers in their discretion to be distributed) should be accumulated as capital. The managers informed the trustee that they proposed to accumulate all income available for distribution in the present year and at all times thereafter. The trustees sought directions from the court as to whether the clause permitting accumulation was valid, notwithstanding the provisions of s164 of the Law of Property Act 1925. This section provides that settlements or disposals of property in such manner that income shall be accumulated for any longer period than as provided in that section, shall be void.

It was held that the provision was valid and that the section did not apply. Wynn-Parry J considered whether s164 applied, and in particular whether investment in a unit trust could be a settlement or a disposition (at 420):

"In my view the word "settle" has no application in this case. Then it is said that in the transaction by which a person becomes a certificate holder a disposition of property is involved. No doubt in one sense a disposition of property is involved, because money or money's worth is paid over, but it is not every disposition to which the section applies. The section only applies to such dispositions as, reading the section as a whole, can reasonably be said to fall within its ambit." He concluded that it did not for a number of reasons, including the view that if the section did apply, "The result...is very curious...This appears to me to afford further support for the conclusion to which I have come, namely, that the section does not apply at all." (at 426.)

To have to conclude that section 53(1)(c) applies to Intermediate Securities so that the rights of all transferees of Eurobonds was merely contractual, would also be very curious.
transferor or holder. This characteristic distinguishes a truly negotiable instrument from an assignment of a debt by a creditor or an instrument which is merely 'transferable' by virtue of trade custom such as a bill of lading. Transferees of a transferable instrument obtain only such title which the transferor himself possessed. Similarly, assignees of debts take 'subject to the equities'...

Adverse equities fall for the present purpose into two categories. "There are generally supposed to be two points at which 'negotiability' affects the rights of the holder of bills and notes. The first has regard to equities affecting liability upon them: and the second relates to the equities of the real owner of the paper, as against some holder of it who claims title through a finder, a thief, or a fraudulent trustee." It is therefore possible to speak of "the issuer's equities" and "the true owner's equities". The true owner's equities are the equitable equivalent of the common law nemo dat rule, which also reflects the principle that the true owner may recover its property.

The general view is that loss of negotiable status necessarily means loss of protection against the nemo dat rule and adverse equities. "A negotiable instrument, for the general convenience of commerce, has been allowed to have an effect at variance with the ordinary principles of law." The traditional view is that, for this reason, the law merchant is more advantageous than the common law. To assess the accuracy of this view, this section will consider the rights of the true owner.

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278 Tennekoon, The Law and Regulation of International Finance, p. 163.

279 The phrase nemo dat quod non habet means, nobody can give that which he does not have. "The rule of the common law is that only the legal owner of goods or one who has been authorized or otherwise held out as entitled to dispose of them can make a disposition which will be effective to divest the legal owner of his title or encumber his interest. In principle, therefore, the owner is entitled to pursue his goods even into the hands of an innocent purchaser for value, and to assert proprietary rights over the proceeds and products of his property." Goode, Commercial Law, p. 60.

280 Ewart, op cit, p. 143. "True owners equities" may also be asserted by an equitable assignee of a debt as against the assignor who remains its legal owner. But where the instrument is negotiable, the debtor may receive a good discharge from the legal owner, even though it has notice of the assignment; (In other words, the rule in Dearle v Hall [1824-341 All ER 28 does not apply to negotiable instruments): Bence v Shearman [1898] 2 Ch 582.

281 per Tindal J in Jenkyns v Usborne, 1844 7 M&G 699, quoted in Ewart, op cit, p. 154.

282 The reputation of the common law has traditionally been low among commercial people: "...it is well if, after great expense of time and money, we can make our own Counsel (being common lawyers) understand one-half of our case, we being amongst them as in a foreign country." (Sir Josiah Child, Discourse about Trade, 1690, quoted in Holden Milnes, op. cit., p 421.)
(a) the rights of the true owner

(i) nemo dat

The law merchant provided one exception to the nemo dat rule in favour of negotiable instruments. If this exception is not available to Intermediate Securities because they are not negotiable instruments, it is tempting to try to find other exceptions that might benefit them. It might have been arguable that the market overt exception was available, but this has now been abolished by statute.283

A better argument is that it is not necessary to find such an exception, because Intermediate Securities are equitable. Nemo dat is a rule of common law, and the common law does not apply to equitable property (such as Intermediate Securities) which it does not recognise.

(ii) true owner's equities

Equity addresses competing claims to assets by considering the priorities between them. The rule is that a bona fide purchaser of the legal estate for value without notice of the prior equitable interest takes free of it.284

Of course, this rule cannot assist in relation to Intermediate Securities for they are equitable and so their purchaser does not acquire a legal estate.285 Thus the purchaser of a eurobond faces two legal problems if

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283 Goods sold in market overt (i.e. within the City of London between the hours of sunrise and sunset) have traditionally been excepted from the nemo dat rule, and the buyer will acquire good title to the goods irrespective of defects in the title of the seller, if he buys in good faith without notice of any defect in title. However the market overt rule was abolished by section 1 of the Sale of Goods (Amendment) Act 1994. It had been judicially argued (by Bayley J, dissenting judgment, Woolery v Pole (1890) 4 B & Ald 1) that the Stock Exchange is the market overt for exchequer bills. Could it have been argued that London bond markets are markets overt?

284 Pitcher v Rawlins (1872) 2 Ch App 259

285 This point is drawn out in the case of Macmillan Inc v Bishopsgate Investment Trust PLC (No. 3) [1995] 3 All ER 747 at 770 in relation to transfers of shares in the DTC. A transfer of shares into the DTC as indirect nominee for a beneficial owner may permit the rule to be invoked; however an intra-DTC transfer cannot, for
he is challenged by someone claiming to be its true owner. Firstly, his investment is not a negotiable instrument and, secondly, his interest is not legal, but merely equitable. What then is his position as equitable owner faced with competing equitable claims?

It is necessary for this purpose to distinguish between equitable interests and mere equities: the first is proprietary and the second is merely personal. The rule is that, upon the assignment of an asset, mere equities do not bind purchasers for value without notice of them. However, an equitable interest will bind all but equity's darling. Intermediate Securities are equitable. It is therefore crucial to determine whether the rights of a true owner are mere equities, or equitable

in such a transfer the legal title does not move.

Also, Roy Goode argues, in Legal Problems of Credit and Security, 2nd, London, Sweet & Maxwell, 1988, that "...the general rule in favour of the bona fide purchaser of the legal title for value and without notice does not apply to the assignment of a debt. This is because section 136 of the Law of Property Act 1925 expressly provides that a statutory assignee of a debt takes subject to equities, and it has been held that a prior equitable interest is an equity for this purpose." In Harding Corp. Ltd. v Royal Bank of Canada [1980] 4 W.W.R. 149, to which Professor Goode refers, it was held that priorities between an earlier general assignment of book debts and later assignment of specific book debts was determined by the order in which notice was given to the debtors, and accordingly went to the later, specific assignee.

286 "An equity is not an existing real right in an asset but rather a personal power in one person to set aside, reduce or extinguish to his own advantage an asset held by another. Equities are broadly of two kinds, those which entitle a person to have revested in him an asset improperly acquired by another and those which entitle him to reduce or extinguish his personal liability to another. Typical examples of the first kind of equity are the right to rescind a contract for fraud, misrepresentation or undue influence..." R.M. Goode, Commercial Law, p. 30. The nature of a mere equity as personal and not proprietary is discussed by Lord Wilberforce in National Provincial Bank v Ainsworth [1955] 2 All ER 472 at 497: "In the authorities, the word [an equity] is used in several senses and for several purposes. Sometimes it is used as referring merely to the exercise of an equitable remedy, such as a remedy by injunction; the thought seems to have been that, since the courts will interfere by injunction to prevent interference with, or departure from, a right, that gives to the proprietor of the right something which is capable of binding not only the other party but his assignees, or successors, provided, of course, that they have notice of the right. In this form, the argument is clearly fallacious. The fact that a contractual right can be specifically enforced, or its breach prevented by injunction, does not mean that the right is any the less of a personal character or that a purchaser with notice is bound by it; what is relevant is the nature of the right, not the remedy which exists for its enforcement."

287 "Whereas an equitable interest is an actual right of property, such as an interest under a trust, a mere equity is not a right of property but a right, usually of a procedural nature, which is ancillary to some right of property, and which limits or qualifies it in some way". Snell's Principles of Equity, 28 ed, 1990, London, Sweet & Maxwell, p. 25.

288 As between competing equities the first in time prevails unless estopped by gross negligence or fraud.
interests. There is authority that (at common law) a fraudulent transfer is no transfer; the defrauded person retains full title. The same principle applies in equity, for equity follows the law. The result is that, under the principles of equitable priority, the true owner's equities will always bind the purchaser of Intermediate Securities.

It will therefore be necessary to find a basis for the integrity of the secondary markets in Intermediate Securities other than the law merchant and the principles of equitable priority.

(b) Estoppel

At the turn of the century, J.S. Ewart argued that the true basis of negotiability is not the law merchant but the common law doctrine of estoppel. While in general choses in action not covered by the law merchant

289 (In the discussion of "true owner's equities" by Ewart referred to in section b below, it is not necessary to clarify this point because the purchaser of the Physical Bonds in question acquired legal title.)


291 There is a special rule of law governing priority of competing assignments of debts and other choses in action. This is known as the rule in Dearle v Hall (1828) 3 Russ; 38 E.R. 475 L.C., and will apply where the same chose in action is assigned, or purported to be assigned, by one assignor to more than one assignee. (Of course, this is different to the issue of true owner's equities, which may be claimed against a holder who claims title through a finder, thief or fraudulent fiduciary. In other words, Dearle v Hall concerns the problem of competing assignments, where true owner's equities arise where there are successive assignments, one of which is bad. Under the rule in Dearle v Hall, the first assignee to give notice to the debtor or trustee takes priority provided it had no notice of any earlier assignment.

292 "There is said to be an estoppel where a party is not allowed to say that a certain statement of fact is untrue, whether in reality it is true or not. [Note: See Co Litt 352a 'Estoppel is when one is concluded and forbidden in law to speak against his own act or deed, year though it be to say the truth'...] Estoppel may therefore be defined as a disability whereby a party is precluded from alleging or proving in legal proceedings that a fact is otherwise than it has been made to appear by the matter giving rise to that disability. Estoppel is often described as a rule of evidence, but the whole concept is more correctly viewed as a substantive rule of law." Halsbury's Laws of England, 4ed, 16.951. See Simm v Anglo-American Telegraph Co. (1879) 5 QBD 118, per Brett L.J. at 206, 207: "The estoppel assumes that the reality is contrary to that which the person is estopped from denying, and the estoppel has no effect at all upon the reality of the circumstances. ... In my view estoppel has no effect upon the real nature of the transaction: it only creates a cause of action between the person in whose favour the estoppel exists and the person who is estopped."

293 In his article, Negotiability and Estoppel, (1900) 14 LQR 135.

294 Indeed he objected to the use of the word "negotiable". "The word 'negotiability' with its double entente is not only unnecessary, it is disturbing and distracting." op. cit. (p. 155).
"must be assigned subject to the equities existing between the original parties to the contract... this is a rule which must yield, when it appears from the nature or terms of the contract that it must have been intended to be assignable free from, and unaffected by, such equities".295

The types of choses in action in whose favour the rule must yield are those in active circulation. "There is a real distinction among choses in action ... namely, between those ‘intended to be assignable’ free from equities, and those not so intended - or, as the present writer ventures to suggest, between ambulatory and non-ambulatory contracts."296 Ewart notes that all instruments treated as negotiable under the law merchant "... have a common characteristic (they are intended to be ambulatory)"297 and argues that this characteristic, and not the law merchant, is the basis for their "negotiability". The test is circulation. "Are they intended to be ambulatory? That is the question. If so, the original contractor cannot set up his equities against an innocent transferee; and a true owner must keep possession, and not, by parting with it, permit the appearance of ownership in another person."298

Applied to Intermediate Securities, this reasoning leads to the pleasing conclusion that the very existence of the secondary market in Intermediate Securities is the legal basis of its integrity: "... we are now fairly well able to say that choses in action pass to a transferee free from equities, where that was the intention of the parties (the wit of man has at length come that far)... "299 Ewart argues that this result is achieved without recourse to the law merchant. "These results are in no way due to the law merchant; they are not in antagonism to the general law; they are part of it ..."300

This section will now consider how these estoppels operate.

295 Re Agra and Masteman's Bank, 1867, L.R. 2 Ch at 397, quoted in Ewart op. cit. at p. 137.
296 Ewart op. cit. p. 142
297 p. 142
298 p. 156
299 p. 158
300 p. 155
(i) **issuer’s equities**

"Estoppel proceeds upon misrepresentation." 301 Ewart argues that, in the case of ambulatory contracts (which might be described as securities in the secondary markets) the issuer is estopped from setting up its equities against a bona fide purchaser by its representation to pay the bearer. "Where there is a distinct promise held out by the company informing all the world that they will pay to the order of the person named, it is not competent for that company afterwards to set up equities of their own." 302 303 In other words, although there may be equities, yet the company is estopped from setting them up ... No support is required from the law-merchant ... 304

This argument can be adapted to assist with Computerised Securities, as follows. The issuer is estopped from setting up equities against the first Intermediary (the common depositary or depositary of the clearer) by its representation to pay the bearer. No such estoppel operates against the first Intermediary in favour of the second Intermediary (the clearer) or the second Intermediary in favour of the Investor. However, no estoppels are necessary. The first and second Intermediary cannot set up equities because, in their hands, the securities are not choses in action owed by them but property which is beneficially owned by another.

This solves the problem of issuer’s equities.

(ii) **true owner’s equities**

The ground is shakier for the argument supporting the estoppel of true owner’s equities. Ewart argues that the true owner is estopped from setting up its equities by the doctrine of ostensible ownership or (where

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301 Ewart, p. 157


303 Lord Herschell’s dictum in *Colonial Bank v Cady* related to common law estoppel; there is also an equitable doctrine of estoppel: See *Re Vandervell’s Trusts* [1974] 1 All ER 47

304 p. 144. Compare the concept of title by estoppel in relation to registered securities, discussed in section C below.
it has entrusted its securities to a broker) by ostensible agency: "...ostensible ownership may often estop a true owner ... from setting up his title as against an innocent purchaser ..." for neglect as to the custody of your property then, be it horses, seals, or transferable documents, may, where other persons are misled by ostensible title in possessors of them, estop the owner from following this property. This is the general law and was not borrowed from the law-merchant." Furthermore, "if the owner of a chose in action clothes a third party with the apparent ownership and right of disposition of it, he is estopped from asserting his title, as against a person to whom such third party has disposed of it, and who received it in good faith and for value."  

It may be hard to extend this doctrine to the markets in Intermediate Securities. The doctrine of ostensible ownership arises on the basis of the neglect of the true owner, and one may be the victim of fraud without neglect. In financial markets where the use of Intermediaries is both customary and commercially necessary, it is difficult to argue that such a practice gives rise to an estoppel. Thus the problem of third party equities still remains.

(c) contractual provision

One approach to this problem is to ask whether the law of contract can provide a basis for the integrity of the secondary markets in Intermediate Securities. Immobilised and Global Securities are issued subject to terms and conditions which are contractually binding on investors who, by

305 pp. 147, 8

306 p. 151. See also the dissenting judgment of Viscount Cave L.J. (with the concurrence of Lord Atkinson) in Jones v Waring and Gillow, Ltd [1926] A.C. 670 (H.L.)


308 See Macmillan Inc. v Bishopsgate Investment Trust PLC (December 1993) (Unreported version), per Millett J at 85: "...where the documents of title are entrusted to an agent and used by him to raise money, the mere possession of those documents by the agent is not enough to raise an estoppel against his principal. In addition there must either be negligence on the part of the principal in parting with the documents, or the agent must have been given actual authority to use them as security." (The reported judgment, [1995] 3 All ER 747, does not include this text.)

309 Another reason for caution with the estoppel approach is the rule that estoppel is a shield and not a sword.
acquiring the securities, agree to be bound by their terms.\footnote{Following the principle in \textit{Clarke v Dunraven} [1897] A.C. 59, in which two contenders in a yacht race were held to have agreed to be bound by entering the race.} These Terms and Conditions could in theory provide that any third party equities will be overreached when a secondary market transaction takes place, although such provision is not customary.\footnote{Similar provision (as between members) is contained in the Reference Manual of the CGO: see sections 8.2.4 and 8.2.5.} Would such contractual provision be effective?

Between the two parties to a transaction, the disposing and the acquiring bondholders (A and B), there is of course privity of contract under the principle in \textit{Clarke v Dunraven}. However, B's concern is not that A will assert adverse equitable interests, but that some third party (C) will do so. If C is a bondholder (i.e. the holder of other bonds forming part of the same issue) at the relevant time, it will be contractually bound under the rule in \textit{Clarke v Dunraven}. However, if C is not a bondholder and subject to the terms and conditions at the relevant time, it will not be contractually bound. It is uncertain whether it would be estopped from asserting its interest against B, particularly if C had at no time in the past been bound by the terms and conditions (for example because it was the beneficiary under a trust of which A was the trustee, the terms of which A breached by disposing of the bonds to B).

Thus, contractual provision may reduce, but cannot eliminate, the problem of third party equities.

(d) \textit{Tracing}

A pragmatic partial solution may be offered by the equitable rules of tracing. These rules were briefly discussed in chapter 2 section 4.c. In legal theory, third party equities may attach to Intermediate Securities in the hands of a purchaser. In practice, however, they may not be able to attach to them, because of the impossibility of actual allocation through fungible accounts. It was shown (in chapter 3 section A.4.b.ii above) that Intermediate Securities are held through accounts at Euroclear and
Cedel which are, in general, fungible. Where Intermediate Securities sold by A to B are subject to equities in favour of C, C may have difficulty in identifying the securities to which its equities attach.

Suppose that C's equities arose because C is the beneficiary of a trust under which A agreed to hold bonds for C. Suppose further that, in setting up this trust, C (as settlor and beneficiary) transferred 50 bonds to A, and that D (a third party) also transferred 50 bonds to A. Suppose A (in breach of the trust in favour of C) subsequently transferred 50 bonds each to B and to E.

Should C seek to assert its equities against B or E, or both of them?

The rules of equitable tracing indicate the answer.\(^{312}^{313}\)

It was shown (in chapter 2 section 3.c above) that, upon the default of the trustee, the remedial proprietary process of tracing arises in favour of the

312 (Tracing through fungible accounts in which the assets are commingled with other assets is only possible in equity, and not at common law: See *El Ajou v Dollar Land Holdings plc and another* [1993] 3 All ER 717, per Millett J at 733, 734: "This makes it necessary to consider separately the common law and equitable tracing rules. In the present case, it is manifestly impossible to follow the money at common law. The international transfers of money were made electronically; the plaintiff’s money was mixed, not merely with the money of other victims or of the fraudsters themselves, but with the money of innocent third parties...however, none of these features creates a problem for equity.")

313 (The relevance of these rules in relation to accounts at Euroclear and Cedel is a matter of private international law. Where the trust in favour of C arises under English law, there is authority that these rules will be applied by the English courts even though the accounts are governed by civil law. See *El Ajou* for authority that trust assets may be traced through civil law jurisdictions.)
beneficiary, permitting it to follow trust assets into the hands of third parties. 314 In order to address cases where trust assets are commingled with other assets, equity went on to develop rules for tracing trust monies and other assets through mixed accounts or funds.

The earlier cases proceeded on the basis of notional allocation where actual allocation was not possible, attributing particular debits in an account to particular credits in accordance with rules that varied with the circumstances. 315

In the late 20th century, financial arrangements and financial fraud have become more complex. While these rules may have worked well in earlier times, they would often be impracticable today. For this reason, the rules have been simplified, in order to obviate the need for even notional allocation.

Where a loss occurs to a global fund due to a common misfortune, the loss will in general be borne ratably by the beneficiaries. This common sense approach was taken in Barlow Clowes v Vaughan 316 where fund investors suffered loss due to the fraud of a fiduciary. It was held that to have sought to allocate particular losses to particular investors would have been impracticable and arbitrary and the losses were therefore borne ratably.

314 See Underhill and Havton, article 95.

315 (1) As between a banker and customer, in a running bank account, it is the sum first paid in, that is first paid out (Devaynes v Noble, Clayton's Case (1816) 1 Mer 572, per Sir Wm Grant MR at 798).

(2) As between a trustee (or other fiduciary) and a beneficiary, where trust monies are mixed with the trustee's own monies in an account operated by the trustee, the latter are in general presumed to be drawn out first (because of a presumption against breach of trust: Re Hallett's Estate, Knatchbull v Hallett [1874 - 801 All ER 793). (Essentially the beneficiary can claim an equitable charge over the account.)

(3) However, as against a trustee acting in breach of trust, this rule may be reversed if it operates to the beneficiary's disadvantage (In re Oatway, Hertsset v Oatway [1903] 2 Ch 357). (Essentially the beneficiary can claim an equitable charge over the account.)

316 Barlow Clowes International Ltd. (in liq.) and others v Vaughan and others [1992] 4 All ER 22. See also Re Eastern Capital Futures (in liq.)[1989] BCLC Ch D 371.
A further recent development in equitable tracing is the concept of the "cascading charge" in the case of *El Ajou Land Holdings plc and another*\(^{317}\).

(Further recent developments in the tracing rules, concerning the need for a continued fund into which assets can be traced, are considered in another context in chapter 5 section D.2.)

These rules can be applied to the scenario outlined above, in which C cannot determine whether his assets are in the account of B or E. Extrapolating from the rule in *Barlow Clowes*, B and E must both meet C's claims in equal portions. Alternatively, under the rule in *El Ajou*, C can choose whether to assert all its claims against B, or all against E, or some against each of them.\(^{318}\) The latter would seem to produce an arbitrary result, and it might be expected that the courts would favour the rule in *Barlow Clowes*.

If the rule in *Barlow Clowes* does prevail, B might derive some comfort from the fact that, where A operates an active account (so that the book entry whereby B took stock from A was not the only debit to A's account on that day), B will be able to share the misfortune of C's adverse interest with other participants, and thereby reduce its losses. Indeed, in

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\(^{317}\) [1993] 3 All ER 717 "The victims of a fraud can follow their money in equity through bank accounts where it has been mixed with other moneys because equity treats the money in such accounts as charged with the repayment of their money. If the money in an account subject to such a charge is afterwards paid out of the account and into a number of different accounts, the victims can claim a similar charge over each of the recipient accounts. They are not bound to choose between them. Whatever may be the position as between the victims inter se, as against the wrongdoer his victims are not required to appropriate debits to credits in order to identify the particular account into which their money has been paid. Equity's power to charge a mixed fund with the repayment of trust moneys (a power not shared by the common law) enables the claimants to follow the money, not because it is theirs, but because it is derived from a fund which is treated as if it were subject to a charge in their favour" per Millet J at 735, 736. (The judgment of Millet J was reversed in the Court of Appeal [1994] 2 All ER 685, although not on this point, but rather on the question of notice. See also the judgment in *El Ajou v. Dollar Land Holdings plc and another* [1995] 2 All ER 213. Support for this "cascading charge" approach is found in *Hallett's case* 1894 2 AB 237 at 245 per Davey LJ, and in *Re Tilley's Wills Trust* [1967] 2 All ER 303.

\(^{318}\) Of course, a clearing system might seek contractually to provide for how tracing (or the allocation of shortfalls following debit entries to accounts) shall operate. For an example, see rule 8.2.6 of the CGO Reference Manual. Such provision is more likely to operate as an estoppel than to alter proprietary rights, and would not be effective against non-participants (i.e. where C is not a participant - a likely circumstance where C is the customer of A).
circumstances where the fraud is not discovered until holdings of the stock has been transferred from the accounts of B and E across the accounts of many other participants, the rule in Barlow Clowes might operate to allocate the shortfall (C's claim) ratably among all participants holding such stock within the clearing system.\textsuperscript{319} Clearly, this would strengthen B's position, by treating third party equities as part of the systemic risk of the system.

(e) private international law

As was argued in above in the context of section 53(1)(c),\textsuperscript{320} a simpler argument can be based in private international law. Under the principles discussed in chapter 6 section D below, the question of whether true owner's equities will bind a purchaser will be governed by \textit{lex situs}. Chapter 7 section C.6 argues that \textit{lex situs} of institutional securities is the jurisdiction of the clearer. In view of the dominant role of the continental clearers, integrity of English transfer may routinely fall to be determined by Belgian and Luxembourg law.

In Luxembourg, Article 7 of the Grand Ducal Regulation of 17 February 1971 Modifying the Circulation of Securities has the effect of transferring the risk of true owner's equities from the purchaser to the clearing system.\textsuperscript{321} The Belgian Royal Decree of 1962 has the effect of defeating unpublished adverse claims once securities have entered the clearing system.

\textsuperscript{319} Of course, tracing would in theory stop at an overdrawn account in accordance with \textit{Bishopsgate Investment Management v Homan} [1994] and \textit{Re Goldcorp Exchange Ltd}. However, in practice, it will be unusual for an account in a clearing system ever to have a negative balance. Both Cedel and Euroclear include provisions in their General Terms and Conditions permitting them to reverse credit entries to inter alia to prevent debit balances arising.

\textsuperscript{320} (at section 1.d)

\textsuperscript{321} The article might be translated into English as follows: "Article 7: At the time of the delivery of a security to a current account with the depositary, the depositary is responsible for verifying that the security is not the subject of any claim which is still valid. In a case where it has accepted or delivered a security which is the subject of such claims, the depositary will be responsible under the general law. Every publication of a claim subsequent to such delivery will be ineffective. In the case of a claim after delivery to current account, the custodian should deliver to the claimant an attestation setting out the date of the deposit in the current account."
As in the context of section 53(1)(c), a problem with relying on this argument is that it prejudices English clearing systems in favour of their overseas rivals.

(f) Conclusions

Although not negotiable instruments, Intermediate Securities are protected from the adverse claims of issuers by the doctrine of estoppel. The risk of third party adverse claims may in practice be so reduced by contractual provision, the rules of tracing and private international law, as to the more theoretical than real.

8. Conclusions

Because they are computerised, Intermediate Securities are not negotiable instruments. In view of this, English domestic law cannot, finally, provide a completely certain and legally robust basis for of the secondary markets in Intermediate Securities. However, English private international law has the probable result that the possible disadvantages under English domestic law of loss of negotiable status (section 53(1)(c) of the Law of Property Act 1925 and true owner’s equities) are inapplicable, because in questions of transfer formalities and competing proprietary claims, it will apply the local law of the clearer. The position under Belgian and Luxembourg law for Intermediate Securities as regards transfer formalities and true owner’s equities is comparable to that under English domestic law for negotiable instruments.

It is ironic that English law should in effect require participants in the bond markets to go abroad to overcome the difficulties it raises, and a legislative solution to these problems would be welcome.

9. Taxation Consequences

This section will consider the taxation consequences of the computerisation of the markets in bearer securities.

a. withholding tax
A concern among the issuers of eurobonds is to retain the benefit of the "eurobond exemption". This concerns withholding tax. There are clear commercial advantages for issuers and investors if interest is to be paid gross. Under section 349(2) of the Income and Corporation Taxes Act 1988 ("ICTA"), interest paid to a person in the UK must in general be paid net of withholding tax, subject to certain exceptions. One exception is created by sections 349(3)(c) and 124, broadly and inter alia in favour of interest paid on any quoted Eurobond held in a recognised clearing system and beneficial owned by a non-UK resident. Cedel, Euroclear and First Chicago Clearing System are currently recognised clearing systems for this purpose. A "quoted Eurobond" is defined as a security which, inter alia, is in bearer form. This raises the following concern. The benefit of the eurobond exemption may be lost in respect of Computerised Bearer Securities, because the interest of the investor in such securities is unallocated and intangible (i.e. not in bearer form).

The concern is more apparent than real, in the case of Immobilised, Global or Repackaged Securities. Although the interest of the investor may not be in bearer form, the global or definitive paper issued by the issuer is expressed on its face to be in bearer form, and it is on this paper that interest is payable by the issuer.

b. stamp duty

For the purposes of stamp duty, the London legal community has considered whether issues of Global Securities may fall for taxation purposes within the definition of a unit trust (on the basis that the second Intermediary was the trustee). It did so because adverse tax consequences would flow from an issue of globals being a unit trust. Firstly, prior to 1988, unit instrument trust duty was payable upon the creation of a unit trust; however, unit trust instrument duty was abolished in 1988. Secondly, transfers of units generally attract stamp duty. In the case of unit trusts expressly established as such, stamp duty is avoided by structuring secondary market transactions as issues and redemptions; while transfers to the manager of the unit trust do take place, these are subject to special provisions. Of course, stamp duty is a tax on instruments of transfer, and will not affect dematerialised transfers. However these may attract stamp
duty reserve tax ("SDRT") which is payable on agreements to transfer chargeable securities.

Chargeable securities are defined in section 99 of the Finance Act 1986 to include units under unit trust schemes. While depositary receipts are exempted from the definition, there is no exemption for interests held through clearing systems. Accordingly, if Global Securities and Immobilised Securities are units in unit trusts, secondary market transactions in them may attract SDRT. This would be particularly hard because the Revenue imposes a triple charge on transfers of securities into clearing systems under sections 70-72 and 96 to 97 of the Finance Act 1986 (equating to a triple charge for depositary receipt arrangements in sections 67-69 and 93-95 of the same Act) on the basis that transfers thereafter will not attract stamp duty.

The taxation definition of unit trust that applied before 1987 might arguably have been wide enough to catch arrangements for Immobilised and Global Securities. Section 57(1) of the Finance Act 1946 used to provide:

"'unit trust scheme" means any arrangements made for the purpose, or having the effect, of providing, for persons having funds available for investment, facilities for the participation by them, as beneficiaries under a trust, in any profits or income arising from the acquisition, holding, management or disposal of any property whatsoever".

However, section 75 was amended by the Finance Act 1987 to follow the definition of unit trust in the Financial Services Act 1986 (subject to exemptions that may be granted by the Revenue but no relevant exemptions have been granted). Section 75(8) of the Financial Services Act provides as follows:

"In this Act -
"a unit trust scheme" means a collective investment scheme under which the property in question is held on trust for the participants;..."

Section 75(1) provides:-
"In this Act "a collective investment scheme" means, subject to the provisions of this Section, any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property of sums paid out of such profits or income."

It may be argued that arrangements for Immobilised Securities and Global Securities do not satisfy this primary definition as the purpose and effect of such arrangements are not participation in or receipt of profits or income. Although that may be the purpose and effect of investment in the underlying issue, the purpose and effect of interposing an Intermediary to create Immobilised or Global Securities are the achievement of settlement efficiencies and compliance with US securities restrictions. In any case, Immobilised and Global Securities are taken out of the definition by virtue of Section 75(2), which provides that:-

"The arrangements must be such that the persons who are to participate as mentioned in sub-section (1) above ... [i.e. Investors] do not have day to day control over the management of the property in question ..."

Since the Intermediary does not have discretionary management powers over the Underlying Property, Immobilised and Global Securities are not collective investment schemes. For this reason, they are not unit trusts for taxation purposes or subject to SDRT. If for any reason Investors delegated management to the Intermediary, SDRT would prima facie be payable. In that case it might be argued that the triple charge amounted to an implicit disapplication of SDRT, or alternatively that SDRT was not payable because secondary market transactions do not involve transfers (along the lines of the argument that they do not involve dispositions for the purposes of section 53(1)(c) of the Law of Property Act 1925: see section 2.c above.)

10. Regulatory Consequences

a. collective investment schemes
For the reasons outlined in section 9 above, arrangements for Immobilised and Global Securities are not collective investment schemes for the purposes of the Financial Services Act 1986.

(However it is arguable that if Investors delegated management decisions to the first Intermediary, the arrangement might fall within the definition of a collective investment scheme. The regulatory consequences of this would be that promotion restrictions would apply under section 76, and that the business of operating the arrangement would amount to investment business requiring authorization under the Financial Services Act 1986. In addition, SDRT might be payable.)

b. balance sheet

The Intermediation of Computerised Securities should not affect their risk weighting for the purposes of regulatory capital. Although, it has been argued, the interest of the investor is equitable, unallocated and generally enforceable only through the Intermediary, the investor does not take the credit risk of the Intermediary, because its interest is protected in the Intermediary's insolvency by a trust. Risk weighting follows credit risk, which remains that of the underlying issuer.

11. General Conclusions

The operational result of the computerisation of debt securities has been intermediation and intangibility. The legal consequence is that computerised debt securities are not negotiable instruments but are interests under equitable tenancies in common. The loss of negotiability does not necessarily entail the loss of the benefits of negotiability. A number of alternative arguments are available under English domestic and private international law to demonstrate that written transfers are unnecessary for secondary market transactions, and it can be shown that the purchaser takes the securities free of any issuer's equities on the basis of estoppel. In theory, it is not entirely clear that, under English domestic law, the purchaser takes free of the true owner's equities. However, modern tracing rules lessen the impact of true owner's equities by spreading the burden of any shortfall ratably among all participants in the relevant clearing system. In any case, English private international law will probably refer questions of adverse proprietary rights to the law of the place of the clearing system in which Intermediate
Securities are held, and the local law of the major clearers addresses these problems. In general, computerisation has no adverse taxation or balance sheet consequences. While the old bases for a legally robust secondary market have been lost, new ones are available. The fundamental legal nature of the securities has changed, but the legal operation of the secondary markets should be unaffected.

C. **Registered Computerised Securities**

The impact of computerisation on the legal nature of registered securities must now be assessed.

1. **Computerisation**

The following are important examples of English Computerised Securities.

a. **CGO**

The Central Gilts Office ("CGO") was established in 1986 as a joint initiative by the Bank of England ("the Bank") and the London Stock Exchange. It is a computerised system for the book-entry settlement of gilt-edged (and certain other) securities between CGO members. The CGO service is operated by the Central Gilts Office of the Bank. An assured payment system provides for payment through settlement banks of the cash consideration for transfers.

Records of members' stock balances are maintained in accounts within the CGO. Intra-member transfers of stock are made by instructions to the system. This contrasts with transfers of stock outside the CGO, which require the delivery of stock transfer forms and stock certificates to the Bank of England registrar. The book-entry basis of the CGO system removes the need for stock transfer forms and stock

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323 Registered securities in computerised form will be referred to as Computerised Registered Securities, and registered securities not in computerised form as Traditional Registered Securities.

324 Transfers of stock through the CGO ("exempt transfers") are removed from the scope of section 53(1)(c) by the provisions of section 1(2) of the Stock Transfer Act 1982.
certificates. Stock transferred through the CGO remains registered on the register maintained by the Bank's registrar. Notification of CGO transfers is made to the registrar by the CGO system. The CGO reference manual provides\(^{325}\) for an equitable interest to pass to the transferee with book entry transfer. Legal title remains determined by the register.

b. \textit{CREST}

CREST is an electronic system for the paperless settlement of corporate securities in London, largely modelled on the CGO. Eligible securities include UK registered corporate equity and debt and interests in foreign corporate securities. Bearer securities are not be eligible.

Under the Companies Act 1985, a company registered under that Act is generally required to issue certificates in respect of shares and debentures\(^{326}\) and to register transfers of shares or debentures only if it receives an instrument of transfer in prescribed form.\(^{327}\) Dematerialisation within CREST is achieved by the Uncertificated Securities Regulations ("the CREST Regulations") made under section 207 of the Companies Act 1989, which permits regulations enabling title transfers to comply with the restrictions in section 136, for the following reasons. Section 136 provides an exception to the general common law restriction on the assignment of choses in action. A more appropriate exemption is provided under a special statutory regime for stock. Section 47(1)(a) of the Finance Act 1942 (as amended by the Stock Transfer Act 1982) permits the Treasury to make regulations providing "for the transfer in law by instruments in writing or otherwise" of government stock. Under this section, the following provision was made in paragraph 4 of the Government Stock Regulations 1965(SI 1965/1420 as amended by SI 1981/1004 and SI 1985/1146), which permits stock to be transferred through the CGO without written instruments.

Outside the CGO, instruments of transfer are currently required by paragraph 4 of the Government Stock Regulations 1965 (SI 1965/1420).

\(^{325}\) in section 8.2.8

\(^{326}\) Section 185(1)

\(^{327}\) Section 183(1).
to securities to be evidenced and transferred without a written instrument. 328

Legal ownership of shares is determined primarily by the register of members of the issuer, which is prima facie evidence of legal title. 329 although the register does not indicate the equitable ownership of shares. 330 331

In CREST (as in the CGO) legal ownership continues to be determined by the register. A CREST member has its name on the register of the issuer and, in addition, has an account at CREST showing a credit balance in respect of its holding. It may acquire new securities from another CREST member by the debiting of the transferor’s account and the crediting of its account. At the same time as this book entry transfer, a registration instruction is sent to the registrar of the issuer, and an instruction issued to the buyer’s settlement bank in respect of the purchase price. Two hours later, the register of the issuer is in general amended in favour of the acquiring CREST member 332. The CREST Regulations provide that, during this two hour settlement interval, the transferee CREST member will acquire a "defined equitable interest" in the securities. 333

328 Section 207(1). (This is very broadly comparable to the Stock Transfer Act 1982 that provided the statutory basis for the dematerialisation of gilts.)

Sections 53(1)(c) and 136 are expressly disapplied to transfers within CREST by the CREST Regulations.

329 See Sections 352 and 361 of the Companies Act 1985. The court has power to rectify the register: section 359.

330 section 360

331 There is no statutory requirement for the issuer of debentures to maintain a register of debenture holders, but in practice it will have to do so if it wishes to issue debentures in registered form. If a register of debenture holders is maintained, sections 190 and 191 of the Companies Act 1985 impose certain requirements concerning such matters as the location of the register and rights of inspection. It is customary to provide in the terms and conditions of the debentures that title will be determined by the register (and this will also be recited on the fact of the certificate). There may also be wording in the terms and conditions providing in effect that the issuer will not be affected by notice of any trusts.

332 (The interval is three days in the CGO.)

333 Regulation 25.
c. depositary receipts

Depositary receipts were discussed in section A.3 above under the heading, repackaged securities. The underlying securities are pooled in the hands of the depositary and the interest of the investor (arising under a trust) is represented by book entry in a clearing system.

d. nature of Computerised Registered Securities

All Computerised Registered Securities are intangible. In addition, repackaged securities are unallocated, and indirect (because of the interposition of the depositary).

It was argued (in section 4.B above) that computerisation has had a profound effect on the legal nature of bearer securities by giving them these characteristics. However, it will be argued that (in the case of registered securities) these characteristics do not represent significant changes, because of the nature of Traditional Registered Securities.

2. Intangible Nature of Traditional Registered Securities

The practice of maintaining registers of ownership of securities developed originally as a means of recording the ownership of joint stock companies. Accordingly the nature of company shares must be considered.

Readily available authority indicates that shares are intangible. A share is not the same as a share certificate, which is not a document of title but a document evidencing title.

334 (although this legal change does not necessarily have adverse commercial consequences)

335 See In re Bahia and San Francisco Railway Co. (1865) Law Report 3 Q.B. 584, per Blackburn J at 595, 6: “When joint stock companies were established, the great object was that the shares should be capable of being easily transferred; and the legislature has made provision... that the company shall keep a register of the members.”

336 A share in a company is the share of its owner in the company’s capital. Shares are personal estate or property (Companies Act 1985 Section 182(1)). A share is a chose in action (Colonial Bank v. Whinney (1886) 11 App CAS 426). The nature of the chose in action is contractual. It arises upon the issue of the share (Re V G M Holdings Limited 1 Ch [1942] CA 235 per Lord Greene MR at 241) under the contract made between the shareholder and the company constituted by the articles of association (Borland’s Trustee v. Steel Brothers &
This chapter will argue that shares are also unallocated and indirect. These features are only apparent when one examines the history of company law, and in particular its debt to the laws of partnership and equity.

3. **Unallocated Nature of Traditional Registered Securities**

The unallocated nature of Traditional Registered Securities owes much to the law of partnership.

a. *partnership*[^337]

In the 16th Century joint stock companies, trading as a single person with jointly contributed capital, became the dominant commercial vehicle.[^338]

The rise of joint stock companies was checked by the South Sea Bubble.[^339]

[^337]: Today the term company is generally used to mean a company incorporated under the Companies Acts, and a distinction is made between corporations (having legal personality and limited liability) and partnerships, having neither. (The registered limited partnership is a hybrid.) However, historically, this distinction was not so clear. There is no necessary link between limited liability and separate legal personality: see R R Formoy, *The Historical Foundations of Modern Company Law*, London, Sweet and Maxwell, 1923, p. 58. Moreover there is some old authority for treating partnerships as having separate legal personality: Holdsworth, Volume III, pp 197, 198.


"...it may be observed that the one permanent effect of the Bubble Act, paradoxically enough, was to help ensure the continued importance in England of the unincorporated joint stock company." 340 Where the Bubble Act had rendered incorporation impracticable, business ventures were conducted through unregistered associations.341 These associations were, at law, partnerships342 with transferable stock.343 Thus, the commercial and financial activity of the industrial revolution was supported largely by the company in the form of a partnership with transferable stock.344

b. **undivided share**

Thus the historical function of the registered security was to serve as the measure of the investor's capital interest in a joint stock company. Registered securities developed as a means of permitting interests in joint stock to be transferable.345 While the terminology used to describe this interest has varied,346 the characteristic that distinguished the joint stock companies from the old regulated companies that preceded them was the

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341 See Dubois, p. 214.


343 "What the government did not foresee was the mobility of the partnership share which business men and lawyers would work out. By the end of the century business conducted in partnership had reached the point where the financial interest was almost if not entirely as liquid as it was with incorporated companies." Dubois, pp. 38, 39.

344 With Gladstone's Joint Stock Companies Act of 1844 the incorporation of companies became possible by public registration, and the formation of large unincorporated commercial associations became unlawful. That and subsequent Acts have prohibited the formation of unincorporated associations for gain having membership exceeding a certain small number (originally 25, and reduced in 1856 to 20 ("the 20 partner rule").

345 See In re Bahia and San Francisco Railway Co. (1865) per Blackburn J at 595, 596.

346 "At the beginning of the seventeenth century the terms "stock" and "share" and "capital" had not acquired their definite modern meaning." Formoy, op. cit., p5. "...the vagueness of contemporary terminology...The words joint stock, capital, capital stock, and fund were used interchangeable to describe the sum total of the proprietors' interest in the company." Dubois, op. cit., p346.
fact that the interest of each investor was undivided.\textsuperscript{347} This is of course reflected today in the balance sheet treatment of registered securities.\textsuperscript{348} It also accords with the historical links between companies and partnerships, because partnership property is held by the partners under a joint tenancy (modified, in the case of company assets, by the exclusion of the right of survivorship)\textsuperscript{349}.

c. \textit{registered debt securities}

Registered securities may be issued in the form of debentures, or as debt as well as in the form of equity. However, registered debt securities as well as shares are unallocated: while shares represent the undivided interest of members of a company in its capital, registered debt represents the undivided interest of co-debtors to an entity in the common debt.\textsuperscript{350}

d. \textit{no identity}

A registered security represents the undivided and indistinguishable interest of the investor in assets which are jointly co-owned by it with all other investors in securities of the same issue. This is because "Unity of possession is a feature of all forms of co-ownership."\textsuperscript{351} Because the assets are not legally divided one from the other, one would expect registered securities to be legally indistinguishable one from the other.

\begin{footnotes}
\item[347] The term "stock" is used in a general way as co-extensive with the whole property, but is more frequently applied to what may be termed the trading or floating capital." Formoy, op. cit., p.6.
\item[348] With, in general, no allocation between the two sides of the balance sheet
\item[349] The characteristic of a joint tenancy is that the interest of each co-owner is undivided.
\item[350] See Holdsworth, op. cit., Volume III, p. 207
\end{footnotes}
The law in this area is somewhat unclear, but the better view is that there is no inherent identity in registered securities. It is impossible to distinguish A's securities from B's securities (except of course by reference to their current ownership), not merely because they are the same as each other, but because they are not divided from each other. "There is no identity in stock." 

**e. numbering of shares**

Between 1862 and 1948 there was a statutory requirement that each share in a company having a share capital be distinguished by its appropriate number. During this interval, directly relevant case law is scarce and contradictory.

In *Ind's Case*, Ind accepted a transfer of 50 shares, executing it in blank as to the distinctive numbers of the shares. These were subsequently inserted. By mistake the numbers inserted were those of shares which did not, at the time of transfer, belong to the transferor (who was, however, the owner of 50 other shares in the company at the relevant time).

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352 In the discussion that follows it is assumed that the securities in question belong to a class, all the securities in which are pari passu and fully paid.

353 This is the position as between the issuer and the investors. The position differs if the interests of third parties are taken into account. For example: Company A issues to both B and C shares in a class all of which are fully paid and pari passu. As between A, B and C, all the shares are the same. If B charges its shares to D, as far as D is concerned, A's shares and B's shares differ in that A's shares (and not B's shares) are subject to its charge. This is a further example of the relative nature of property discussed in chapter 3 above. In this discussion the interests of third parties will not be considered further.

354 *Bank of England v Cutler* (1907) 1 KB 889, per Lawrence J at 909.

355 Companies Act 1862, s 22; Companies (Consolidation) Act s 22(2); Companies Act 1929 s 62(2).

356 *Re the International Contract Company* (1872) 7 Ch App 485.
On a winding up Ind argued that he was not a member. It was held (on appeal) that the transfer had passed 50 shares to Ind, who was therefore not entitled to have his name removed from the list of contributories.\textsuperscript{357}

However, the later case of \textit{Platt v. Rowe}\textsuperscript{358} takes another approach. In this case, P brought certain numbered shares in a company through his stockbroker. At the relevant time the transferor was not registered as owner of the particular shares, which had been allotted to other persons, because "... there was something like chaos in the transfer department of the company [and] ... the intemperance of a certain portion of the staff led to confusion ...".\textsuperscript{359} P was issued a certificate by the company, but subsequently sued the vendor to recover the purchase price. It was held that P was entitled to recover, for there had been a total failure of consideration.\textsuperscript{360} "The law requires that each share shall be numbered in order that it may be identified and that the title to it may be traced".\textsuperscript{361,362}

\textit{Ind's Case} is cited with approval in the Australian case of \textit{Brady v Stapleton}.\textsuperscript{363} Apart from this, it has proved impossible to find any cases in which either of these contradictory judgments is discussed. It seems

\textsuperscript{357} I think that the numbering of the shares is simply directory for the purposes of enabling the title of particular persons to be traced, but that one share, being merely an incorporeal right to a certain portion of the profits of the company, is the same as another, and that share No 1 is not distinguishable for that purpose from share No 2, in the same way that a grey horse is distinguishable from a black horse. Practically one share is not distinguishable from another, and if a holder of shares, who had the same number of shares or a larger number than what he professed to transfer, executed a deed of transfer to so many shares, and by mistake the wrong numbers were put in the transfer, that would not prevent the fifty shares which belonged to him from passing to the transferee. The numbers might afterwards be rectified. (Per Mellish L.J. at 487.)

\textsuperscript{358} (1909) 26 TLR 49.

\textsuperscript{359} per Swinfen Eady J. at 51.

\textsuperscript{360} "No transferor could transfer any shares which had not already been allotted or transferred to him, and his document of title to the shares would show the number of shares to which he was entitled, and he could only transfer those and no others" per Swinfen Eady J. at 51.

\textsuperscript{361} per Swinfen Eady J. at 51.

\textsuperscript{362} Ind's Case is distinguished on the dubious grounds that the decision in Ind's Case was based on the fact that the wrong number was inserted in error, rather than the view that numbers are unnecessary. per Swinfen Eady J. at 52.

\textsuperscript{363} [1952] 88 CLR 322.
that the principle in *Ind’s Case* (that individual identification is not necessary) should be favoured over that in *Platt v Rowe*, which indicates that the individual identification of particular shares is both possible and a necessary precondition of their transfer. This proposition is untenable today, when listed shares are unnumbered. It is also at odds with the historic nature of registered securities, which is unallocated.

In 1948, numbering became optional for (broadly) shares in a class all of which are pari passu and fully paid. In the recorded debate of the relevant section in the bill that introduced this change, the reason for the end of compulsory numbering was not discussed. It was presumably introduced to facilitate secondary market transfers, and is certainly a strong indication that the rule in *Platt v Rowe* (that individual identification of shares is a pre-condition for transfer) is not good law. Commercial numbering systems identify issues of securities but do not identify particular securities within an issue. Accordingly, case law and commercial and official practice indicate that individual registered securities do not have inherent identity.

f. *fraudulent transfer cases*

Case law relating to fraudulent transfers of registered securities also indicate that Traditional Registered Securities are unallocated.

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364 And therefore not individually identifiable. In theory, one might seek individually to identify unnumbered securities by tracing them through the hands of their successive owners from time to time. However, actual (as opposed to notional) tracing would depend upon a record of transfers. In practice no such record may be maintained. While it has been recommended that registers of transfers should be maintained as a matter of good secretarial practice (see Boyles & Sykes, *Gore Brown on Companies*, 44ed, Jordons, Bristol; 1986, s16.3) there is no legal obligation to maintain them. Moreover the impracticability of actual tracing registered securities through the hands of successive owners was emphasised in *Davis v. Bank of England* (1842) 2 Bing 393: "Indeed, from the manner in which stock passes from man to man, from the union of stocks bought of different persons under the same name, and the impossibility of distinguishing what was regularly transferred from what was not, it is impossible to trace the title of stock as you can that of an estate". (per Best C.J. at 408)

For authority that identification is a not a necessary precondition of the transfer of registered securities, see the discussion of *Hunter v Moss* in chapter 5 below.

365 By Companies Act 1948 s74, replaced by Companies Act 1985 s 182(2).
In re Bahia and San Francisco Railway Company\textsuperscript{366} concerned a fraudulent transfer of shares from A to B1 and B2. B1 and B2 were registered and a certificate was issued. The shares were then transferred through the Stock Exchange from B1 and B2 to C. The fraud was discovered and the Court ordered A's name to be restored to the register. C sued the company. It was held that C was entitled to damages from the company equal to the value of the shares at the time of the rectification of the register. The basis of the decision was estoppel\textsuperscript{367}. The estoppel was founded on the implied warranty of title by the company in issuing the share certificate to B1 and B2. While the estoppel rendered C entitled to damages\textsuperscript{368}, it did not pass title to C. Title remained with A, for a forged transfer is no transfer\textsuperscript{369}.

In Bank of England v Cutler\textsuperscript{370} the Courts marked the turn of the century by showing greater concern for the integrity of the secondary market. The subsequent transferee's position was not disturbed, and new stock was brought in the market in order to restore the registration of the original stockholder. "When the forged transfer is said to be a nullity, that merely means that it has no effect upon the [original] stockholder's property; the title to £1544 15s worth of stock remained intact. But the subsequent transfers cannot be struck out of the Bank books except as the result of an action wherein the transferees have been shown to be affected by complicity in the fraud. Prima facie a transfer which the Bank has permitted is valid, and if acted upon bona fide and for value the Bank is estopped as well from touching it as from saying that it is invalid"\textsuperscript{371}.

\textsuperscript{366} (1865) Law Rep 3 QB 118

\textsuperscript{367} "Having, therefore, put the names of [B1 and B2] upon the register and granted them a certificate the company are estopped after that statement has been acted upon, and cannot deny that those persons were the legal holders of the particular shares which have been transferred to the claimants". (Per Lush J at 698).

\textsuperscript{368} The correct measure of damages was considered further in re Otros Kopje Diamond Mines Ltd [1893] 1 Ch 618. It was held to be the value of the shares on the date when the company refused to register the transferee.

\textsuperscript{369} "It turn out that [B, and B2] had in fact no shares, and that the company ought not to have registered them as shareholders or given them certificates, the transfers having been a forgery" (per Cockburn C J at 595).

\textsuperscript{370} [1907] 1 KB 889

\textsuperscript{371} per Lawrence J at 908.
This builds on a concept of right, or title by estoppel that was discussed, obiter, in the judgment of Cotton L J in Simm v Anglo-American Telegraph Co\textsuperscript{372}. He described "title by estoppel" as a species of title which is not transferred through the fraudulent transfer, but which arises de novo (as against the issuing company) on the basis of the estoppel.\textsuperscript{373} Thus, the title of bona fide purchasers are prima facie valid\textsuperscript{374} on the basis of title by estoppel, which is not transferred, but arises de novo. The fraudulent purported transfer of existing property can bring new property into being.\textsuperscript{375}

The point is well illustrated in Bank of England v Cutler. Following the fraudulent transfer, the name of the original stockholder was removed from the register, and later restored to the register. During this period, her property and title were unaffected.\textsuperscript{376} The case indicates that her interest was quantitative and not qualitative, in the sense that her property and title did not attach to particular units of stock.\textsuperscript{377}

\textsuperscript{372} (1879) 5 QBD 188 at 213, 216.

\textsuperscript{373} "If [D] had sold in the market the 5000\$ of stock belonging to A, an innocent purchaser would have acquired a title by estoppel against the company; not because [D] had transmitted to him any title of their own, but because he had acted upon the faith of the representation made by the company in issuing the certificate". at 216.

\textsuperscript{374} see Cutler v. BoE, per Lawrence J, at 908.

\textsuperscript{375} There does not seem to be any analogy in the law relating to transfers of other forms of personal property. The various exceptions that are available to the rule \textit{nemo dat quod non habat}, are not based on the creation of new proprietary rights, but the transfer of exiting ones (albeit not those of the transferor. Equally, the rule in Dearle v Hall (whereby priority as between successive assignees of a debt or other chose in action is governed by the order of notice to the debtor, so that a second assignee may acquire title to debt which was no longer the assignor’s to give) does not create new proprietary rights, for the first assignee’s rights are postponed to those of the first assignee to give notice.

\textsuperscript{376} The forged transfer "... had no effect upon the stockholder’s property, her title to £1544.15s worth of stock remained intact". per Lawrence J at 908. It should be noted that her title was to "£1544.15s worth of stock", not to particular stock.

\textsuperscript{377} Indeed the judgment prevents one from considering her interest in qualitative terms. If her interest had consisted of a particular parcel of stock, it must have ceased to attach to the original stock when that was transferred from her, and can only have attached to the new stock when that in turn transferred to her. However the judgment indicates that her title to stock was continuous. Although the Bank was under a duty to buy in stock in order to eliminate any dilution of the total stock in issue, this buying in was not a pre-condition of the stockholder’s proprietary interest, for she never lost it. "... [W]hen this had been done her property in law and her apparent title upon the books would once more accord". per Lawrence L J at 908.
There is no identity in stock. Issues of Traditional Registered Securities are divided into units for the purpose of quantification, but not for the purpose of individual identification, for they are undivided.

g. contrast bearer securities

In their unallocated nature, traditional registered securities differ from physical bearer securities, which are historically derived, not from joint stock enterprises, but from commercial trading debt. Although today both registered and bearer securities are launched in the primary market in large issues, physical bearer securities were issued singly long before they were issued in large numbers together. Traditional registered securities were never issued singly. A traditional registered security represents an unallocated share of a larger fund, whereas a Physical Bearer Security constitutes a distinct debt: it is constituted by a separate covenant to pay, or chose in action in favour of the holder, whereas a registered security is a fractional share in the obligation of the issuer.

4. The Indirect Nature of Traditional Registered Securities

a. Repackaged Securities

The repackaging of securities into depository receipts involves the intermediation of a depository, who holds its interest in the underlying securities on trust for investors. Their interest is indirect and equitable. This does not represent a radical departure from position of with Traditional Registered Securities, which historically owes much to the law of trusts.

b. equity

Unincorporated companies sought to address the legal difficulties associated with the lack of legal personality, by appointing trustees under a deed of settlement. The trustees could hold and convey the company's

378 per Lawrence J at 909.
assets, and bring any actions in the name of the company.\textsuperscript{379} "We have seen that much can be done under cover of a trust without the necessity for a grant of incorporation."\textsuperscript{380} While the common law would govern the relations between the trustees and the outside world, the internal affairs of the company (including its winding up\textsuperscript{381}) were governed by equity.\textsuperscript{382} Another reason for avoiding the common law courts was the irregular status of these associations during the currency of the Bubble Act.\textsuperscript{383} Equitable jurisdiction over unincorporated commercial associations was well established by the late 17th century.\textsuperscript{384}

Registered shares were brought out of equity and into the common law by the Joint Stock Companies Act of 1856, which replaced the deed of settlement with a memorandum of association, and thereby ending the central role of the trust in the constitution of companies. However, it is still customary for issues of registered debentures to be made under a trust deed, so that registered corporate debt remains in most cases equitable and not legal.

5. Summary

The computerisation of registered securities has not changed their fundamental legal nature, as both Traditional and Computerised Registered Securities are intangible and unallocated. However, while undoubtedly simplifying the law relating to the transfer and evidencing of registered securities by removing the

\textsuperscript{379} "The constituting of trustees for the company got over the difficulty that the company as a fluctuating body had in suing." Formoy, op. cit., pp. 41, 42.

\textsuperscript{380} Holdsworth, op. cit., Volume IV, p. 47.

\textsuperscript{381} See Formoy, op. cit., pp. 75, 89, 93.

\textsuperscript{382} "When difficulties of internal operation arose in the case of the unincorporated association, the only possible forum where adequate relief could be obtained was the Chancellor’s court." Dubois, op. cit., p. 227.

\textsuperscript{383} "Since the unincorporated company was definitely not “the creature of the state,” the state in its turn was less accessible to such a unit. ....Nevertheless, for a century in which the business man was at great pains to shun the courts, the unincorporated association did make fairly frequent use of the aid of the Court of Chancery, which by closing its eyes to the legal irregularity of the unincorporated group with a joint stock, adhered to its well-established practice of welcoming new litigants." Dubois, op. cit., p. 227.

\textsuperscript{384} See Holdsworth, op. cit., Volume IV, p. 218.
need for paper, computerisation does raise important secondary legal issues for registered securities. Two examples relate to debenture status, and fraudulent transfers.

6. **Debentures**

A borrowing, or document relating to it, which falls within the meaning of the term 'debenture' attracts many statutory provisions. It is therefore important to determine whether Computerised corporate debt fall within the definition of debenture.

Gore-Browne goes on to consider the meaning of the term under the common law, in the Companies Act 1985 and in the Financial Services Act 1986. None of these provides a precise or narrow definition, but it is clear that for the purposes of each, the term involves the common law concept of a document creating or acknowledging a debt. It has been argued that an intangible cannot be an instrument. Can it be a document?

Jowitt's Dictionary of English Law defines "document" as "any solid substance upon which matter has been expressed or described by conventional signs, with the intention of recording or transmitting that matter." The term is not limited to paper or writing, and includes visual and sound recordings. However it has not been possible to find any authority that the term includes intangibles such as computer records. This may of course be because the

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385 These are enumerated in detail in Gore-Browne on Companies, Boyle & Sykes 44ed, Jordans, London 1994, volume 1, at 17.14 and include requirements under the Companies Act 1985 relating to certificates, registers, trust deeds and registration of charges, the inclusion of a debenture within the definition of investment in the Financial Services Act 1986, so that business in debentures may be regulated under that act, and the ability to appoint an administrative receiver under the Insolvency Act 1986.

386 At 17.14.1 to 17.14.3.

387 (in chapter 3 section [B.3.b])


389 See the Civil Evidence Act, 1968 section 10(1) (visual and sound), *Standen v Licensing Control Commission* [1990] 2 NZLR 722 at 725, per Greig J (sound), *Grant v Southwestern and Country Properties* [1975] Ch. 185 (sound, for the purpose of R.S.C. O.24 r.10(1) and *Senior v Holdsworth*, ex p. *Independent Television News* [1976] Q.B. 23 (visual, for the purpose of R.S.C. O. 24 r. 10(1)).
relevant decisions and statutory provisions date from a pre-electronic era. However, the prudent view is that an intangible is not a document and therefore not a debenture.

Where corporate debt is dematerialised in CREST, debenture status may be preserved by identifying some tangible document associated with the issue. Where the debt is constituted by a trust deed, this may be treated as a debenture. Otherwise, any written instrument recording the terms of issue of dematerialised debt may serve the purpose. In each case, it should be possible for the issuer to identify some document connected with the issue that creates oracknowledges debt, and thereby attracts debenture status.

7. **Fraudulent Transfers**

The law relating to fraudulent transfers of Traditional Bearer Securities (discussed in section B.7 above) favours the holder in due course at the expense of the defrauded true owner. In contrast, in the case of Traditional Registered Securities, both the bona fide transferee and the defrauded true owner are favoured at the expense of the issuer.

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390 See, for example, *Hill v R* [1946] K.B. 329 at 333. per Humphreys J: "To constitute a document, the form which it takes seems to me to be immaterial; it may be on anything on which the information is written or inscribed - paper, parchment, stone or metal."

391 Most domestic sterling debt is so constituted. Only unquoted domestic debt, for example that issued as consideration in a takeover, may not have a trust deed. In the euromarkets, however, a trust deed is optional.

392 It was shown (in chapter 2 section 3.b.ii above) that common law historically restricted the assignment of choses in action, and that bearer securities became transferable under the law merchant as an exception to this restriction. The law merchant does not concern registered securities. The historic basis for the transferability of registered securities must, then, be determined.

"Stocks and shares were in early days expressly made assignable by charter or Act of Parliament" (Holdsworth, op. cit., Volume VII, p. 542) or by royal charter, although, as early as the 16th century, there was doubt as to whether the common law restriction applied (Holdsworth, op. cit., pp. 202, 203). One might speculate that one reason for doubt was the view that, in respect of the registered securities of unincorporated associations, assignments could take place only in equity (as the securities only existed in equity) and were not subject to the common law rule for that reason.

In any case the present statutory regimes for the transfer of registered securities are currently provided by the Stock Transfer Act 1963 in the case of traditional equities and gilts, the Stock Transfer Act 1982 in the case of dematerialised gilts and the Companies Act 1989 in the case of dematerialised corporate securities.
In the historic development of this principle, the issuing corporations led the way that the courts came to follow. The risk of fraudulent transfers of registered securities was borne voluntarily by the issuing companies' management in order to encourage the secondary markets in their shares. This approach was subsequently taken up by the courts in the late eighteenth century. In the nineteenth century the shift from policy to was consolidated as the legal basis for the approach was developed in a large body of case law. The rule that the issuer should bear the risk of fraudulent transfers of registered securities rests on the doctrine of estoppel, which operates against the issuer on the basis of the representations made in the register of members.

The principles emerging from this case law may be very broadly summarised as follows.

(a) A forged purported transfer is no transfer, and title remains with the original holder;

(b) both in equity and at law.

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393 "It was not until the latter part of the century that the courts decided whether the risk of loss should fall on the proprietor whose stock was fraudulently transferred, on the purchaser in good faith, or on the corporation. Nevertheless, with the question of the negotiability [in the old sense of transferability.] of their stock at stake, the large business corporations tended to assume the risk of loss. With the South Sea Company, in 1722, a decree of the Master of the Rolls embodying an application of the caveat emptor rule to the situation was received favourably by the directors. However, the general court [i.e. the general court of directors of the company] voted to protect both the original proprietor and the purchaser if both were the victims of fraud. The original proprietor would be permitted to retain the stock, and the purchaser would be given an equivalent amount in treasury stock.

A similar attitude was taken by the court of directors of the Bank of England, the Royal African Company, and the London Assurance Corporation, but it was not until 1765 that this boon to the cause of the security of transfer of stock had its official recognition in the courts. [Note: Ashby v Blackwell and the Million Bank, Amb 503 (Chancery, 1765).] It was held to be the duty of the company to save harmless both the bona fide purchaser and the original proprietor, a decision that reflects the fact that the shareholder was a real proprietor, in the sense that he was regarded as having an interest in the company of which he could not be involuntarily divested." (Dubois, op. cit., pp 361, 362.)


395 Midland Ry Co v. Taylor (1862) 8 HL Cas 751, per Lord Westbury LC at p756.
(c) The original holder is entitled to require the issuer to restore its name to
the register (and to receive sums equal to dividends lost due to the
transfer);\(^{396}\)

(d) unless its own conduct (through fraud or gross negligence) amounts to a
ratification of the fraud, or an estoppel against suing the issuer.\(^{397}\)

(e) In order to grant restitution to the original holder, it is not necessary to
trace the securities in question nor to join their current holder.\(^{398}\)

(f) The issuer is estopped from denying the title of the subsequent bona fide
purchaser of the securities;\(^{399}\)

(g) however no estoppel arises in favour of the direct transferee (X) under a
forged transfer;\(^{400}\)

(h) nor in favour of a subsequent transferee if it holds the securities
beneficially for X.\(^{401}\)


\(^{397}\) Welch v. Bank of England [1995] 1 All ER 811. Gross negligence will defeat the original holder’s claim (Coles v Bank of England (1839) 10 AD & E 437) but mere negligence will not unless it amounts to an estoppel (Bank of Ireland v Evans Charities Trustees (1855) V HLC 389).

\(^{398}\) Barton v London & NW Ry Co (1888) 38 ChD 144; Sloman v Bank of England; per Sir L Shadwell at 447, 448; the rule is also implicit in all the other cases relating to forged transfer and referred to in this section.

\(^{399}\) In re Bahia and San Francisco Pry Co. “Having, therefore, put the names of [the transferees under the fraudulent transfer] upon the register, and granted them a certificate, the company are estopped after that statement has been acted upon, and cannot deny that those persons were the legal holders of the particular shares which have been transferred to the claimants.” Per Lush J at 598. Some cases emphasise the register as the form taken by the issuer’s representation; others (for example, In re Ottos Kopje Diamond Mines, Ltd (1893) 1 Ch 618, per Bowen L.J. at 628) emphasize the certificate.

\(^{400}\) Simm v. Anglo-American Telegraph Co (1879) 5 QBD 188

\(^{401}\) Simm v. Anglo-American Telegraph Co.
(i) In having regard to both the original holders' rights of restitution and to the estoppel in favour of the bona fide purchaser, the issuer must avoid diluting the securities in issue.\textsuperscript{402}

(j) Dilution is in practice avoided (in the more recent cases) by the issuer buying securities in the market for the account of the original holder.\textsuperscript{403}

(k) The issuer is entitled to an indemnity from the broker\textsuperscript{404} (or transferee)\textsuperscript{405} presenting the fraudulent transfer (however innocently), on the basis of an implied warranty that the transfer is valid.

Thus, the market integrity is achieved in the secondary markets in Traditional Registered Securities by placing the risk of fraudulent transfers on the issuer; the basis for this is estoppel, arising from the representation made by the issuer in the register as to the ownership of the securities and by the issue of a certificate.

These arrangements are disturbed by computerisation. No certificates are issued.\textsuperscript{406} In the case of depositary receipts, the register of the issuer is uninformative as to the identity of investors (for the register shows only the name of the depositary). The Government Stock Regulations\textsuperscript{407} limit the liability of the Bank (regulation 22A) (in effect) for fraudulent transfers, although the defrauded owner's recourse against third parties is unaffected (regulation 22B). Thus, in the case of DRs and CGO stock, investors are not protected as they are with Traditional Registered Securities. In the case of CREST securities, no statutory provision alters the traditional position, so presumably the issuer is still liable in respect of registered fraudulent transfers

\textsuperscript{402} Bank of England v. Cutler (1908) [1907] 2 KB 889 per Lawrence J at 908, 909.

\textsuperscript{403} Sheffield Corpn v. Barclay, HL (1904-7) All ER Rep 747; Bank of England v. Cutler, per Lawrence J at 909.


\textsuperscript{405} Sheffield Corpn v. Barclay.

\textsuperscript{406} In any case, gilts certificates cannot give rise to estoppel: Government Stock Regulations 1965 regulation 7 (SI 1965/1420).

\textsuperscript{407} SI 1965/1420
on the basis of the representation made by registration. However, the CREST Regulations severely limit the issuer’s ability to decline to register transfers that may be fraudulent\textsuperscript{408} and thereby protect itself from such liability.

D. Conclusions - Bearer and Registered Securities

1. Generally

This chapter has considered the consequences of computerisation for the legal nature of securities. It has been shown that, for bearer securities, computerisation has forfeited negotiability and therefore changed the legal nature of the securities. However, in practice the secondary markets should not be affected, as the benefits of negotiability are available by other means. In the case of registered securities, computerisation has no profound effect on the legal nature of the security. As creatures of equity, they are intangible, unallocated and indirect, and need little adaptation for the computerised environment. Debenture status should in practice be preservable. However, without the cross-border arguments that assist the bearer bond markets (which are dominated by the European clearers), the traditional basis for integrity of secondary market transactions may no longer be available.

2. Registered and Bearer Securities

To return to the changes in the nature of bearer securities caused by computerisation, in section B.4 above it was shown that the effect of computerisation was (broadly speaking) to turn bearer securities from negotiable instruments into Intermediate Securities. It was noted that Intermediate Securities are unallocated, intangible and equitable. The difference between bearer and registered securities might be summarised as follows:

(i) \textit{unallocated and allocated} While the interest of the holder of a registered security is unallocated, the interest of the holder of a bearer security is allocated; a bearer security is not an undivided share of a larger fund co-owned with other investors, but a distinct debt owed by the issuer to the bearer alone and constituted by the instrument.

\textsuperscript{408} regulation 23
(ii) **intangible and tangible** While registered securities are intangible and certificates in respect of them are merely evidence of title, in the case of bearer securities the chose in action against the issuer is locked up in the bearer document, which is a tangible document of title.

(iii) **equity and the law merchant** While the law relating to registered securities owes much to equity, bearer securities are the creation of the law merchant.

On this basis, it is submitted that the effect of computerisation has been to turn bearer securities into registered securities.
Chapter 4. Computerisation and the custody relationship

The effect of computerisation on the legal nature of securities has been considered. Its effect on the legal nature of the custody relationship will now be assessed.

1. The Traditional View

The global custodian usually maintains two types of account in the name of the client: securities accounts and cash accounts. The cash from time to time credited to the cash accounts may represent the proceeds of sale of custody assets, dividends and other income received in respect of custody securities.

Both the cash and the securities accounts represent choses in action owned by the client. The cash accounts represent debts owed by the custodian. The securities accounts represent choses in action owed directly by the underlying issuer, and held for the client by the custodian as bailee.

2. Cash

a. The Debtor/Creditor Principle

Custodians have traditionally been banks. It is a clearly established principle that the deposit of cash with a bank establishes the relationship of debtor and creditor between the bank and the depositor\(^4\text{lo}\). Customers money is not held by the bank by way of trust\(^4\text{l}\). The bank is free to use the deposited money as it pleases\(^4\text{12}\) and the depositor’s rights of repayment are contractual and not

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410 *Carr v. Carr* (1816) 1 MFR 625.


412 *South Australian Insurance Co v. Randell* (1869) 16 ER 775 at 759.
proprietary\textsuperscript{413}. On the bank's insolvency, therefore, the depositor must prove as an unsecured creditor\textsuperscript{414}.

It has generally been assumed that the debtor/creditor principle applies to custodians in respect of clients' cash accounts.\textsuperscript{415} Custodians generally conduct their business on the basis that it does, using the money credited to the custody cash accounts for their own purposes, and not segregating it as trust money. While this approach is probably correct, two points arise. The debtor/creditor principle applies to money deposited with banks. Custodians may not be banks, and the credit balance of the custody cash accounts may not represent deposits.

b. Trust Over Cash

The credit balances of the cash accounts may represent, not deposits, but rather the proceeds of sale of custody assets or income derived from custody assets. Section 3 below will argue that (notwithstanding the traditional view), in a computerised environment, custody assets may in most cases be held by the custodian not as bailee but as trustee for the client. The proceeds of sale of trust property\textsuperscript{416}, and income derived from trust property\textsuperscript{417}, are generally if subject to the same trusts as the property to which they relate. This raises the risk for custodians of a duty to segregate cash.

The answer to this problem for the bank custodian is provided by the case of Space Investments\textsuperscript{418}. In this case it was held that, where a bank trustee lawfully deposits trust money with itself as banker, it becomes beneficially

\textsuperscript{413} "True it is that in the case of money paid into the banker's account it is converted into a debt, while in the case of money placed in a special repository it remains in specie". Re Halletts Estate, Knatchbull v. Hallett [1874-80] All ER 793 per Thesiger L J at 746.

\textsuperscript{414} Space Investments Ltd v. Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd [1986] 3 All ER 75.

\textsuperscript{415} Barings Brothers & Co. Limited is a global custodian. In March 1995, after the company went into administration and before the announcement of the agreement of ING Bank to buy the Barings group and take over its debts, it was generally assumed that the balance of the cash accounts held by the company for the pension funds which were its custody clients was at risk. This money amounted to some £100 million.

\textsuperscript{416} See Re Halletts Estate, Knatchbull v. Hallett [1874-80] All ER 793.

\textsuperscript{417} Swain v The Law Society C.A. [1981] 3 All ER 797, 813, per Lord Justice Oliver.

\textsuperscript{418} Space Investments Ltd v. Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd [1986] 3 All ER 75.
entitled to that money, and owes only a contractual duty of repayment. In order to be certain of benefiting from this rule, bank custodians should consider including express wording in their custody agreements, authorising them to deposit any trust money credited to the cash accounts with themselves as banker.

Under the Client Money Regulations, client money held by persons authorised under the Financial Services Act 1986 in connection with investment business must in general be held on a statutory trust in accordance with those regulations. However, the regulations do not apply to an approved bank, insofar as it holds money on behalf of its clients in an account with itself. "Approved bank" is defined to include (in respect of accounts opened in the UK) an institution authorised under the Banking Act 1987. Moreover, a pure custodial service (i.e. one involving only safekeeping, settlement and administration) does not involve investment business for the purposes of the Financial Services Act, so that the Client Money Regulations will not apply. (However, the SIB has indicated that it may bring custody within the scope of regulatable investment business in the near future.)

c. Deposit-taking business

Section 3 of the Banking Act 1987 provides that no person shall in the United Kingdom accept a deposit in the course of carrying on a deposit-taking business other than an authorised institution. Breach of section 3 is a criminal offence.

While the point is arguable, it would be prudent to assume that the maintenance of a custody cash account may amount to deposit taking business for this purpose. Paragraph 14 of the Banking Act 1987 (Exempt Transactions)
Regulations 1988\textsuperscript{422} creates an exemption in favour of the acceptance of deposits (broadly) by a person who is authorised under the Financial Services Act 1986, if accepted in the course of or for the purpose of engaging in dealing, arranging deals, managing investments or operating collective investment schemes with or on behalf of the depositor. Custodians are generally (but not universally) so authorised. However, it would be prudent to assume that the provision of the core custodial services does not amount to an "investment business" activity for the purposes of the exemption.

Therefore any global custodian which is not a bank should maintain a custody cash account as client money in the name of the client with a third party bank and operate the account as trustee on the client's behalf.

3. **Securities**

The traditional characterisation of the custodian in respect of securities\textsuperscript{423} (and other non-cash assets such as bullion\textsuperscript{424}) is as the bailee of the client. "A bailment arises whenever specific goods are delivered into the possession of someone other than the person immediately entitled to them, on condition that those identical goods are returned to the deliveror or disposed of in accordance with his instructions when the purpose of the bailment is fulfilled".\textsuperscript{425} \textsuperscript{426} The essence of bailment is the delivery of possession (as opposed to the delivery of title)\textsuperscript{427} by the bailor to the bailee. Thus, the custodian has

\textsuperscript{422} SI 1988/646 (as amended).

\textsuperscript{423} "These bonds are her bonds deposited with Mr Hallett according to the receipt, for safe custody, which would make him, no doubt, an ordinary bailee". Re Hallett's Estates, Knatchbull v Hallett [1874-801 All ER 793, per Jessell MR at 708. See also Kahler v. Midland Bank, HL (1950] AC 24.


\textsuperscript{425} N E Palmer, Liability of Bankers as Custodians of Client Property, 1.

\textsuperscript{426} See also the classification of bailments in the judgment of Holt, C.J. in Coggs v Bernard (1703) 2 Ld. Raym 909.

\textsuperscript{427} In addition to possession of the bailed assets, a bailee has a limited proprietary interest in them which is based on possession. However, this interest, called "special property", is less than title. "So feeble and precarious was property without possession, or rather without possessory remedies, in the eyes of medieval lawyers, that Possession largely usurped not only the substance but the name of Property; and when distinction became necessary in modern times, the clumsy term 'special property' was employed to denote the rights of a possessor not being owner". (Pollock, An Essay on Possession in the Common Law, 1888, Oxford, Clarendon Press, p. 5.)
possession of the custody securities, but they are owned by the client and are unavailable to the creditors of the custodian upon its insolvency.

This traditional view of the custody relationship is challenged by computerisation for a number of reasons. The chief of these is dematerialisation. As discussed in chapter 3, securities are increasingly intangible, they are therefore incapable of possession and bailment. This section will argue that the natural characterisation of the modern custody relationship under English domestic law is therefore not bailment, but trust (with the consequent commercial need for the custodian carefully to limit the level of its duties by contract).

a. Ownership

"... [A] conveyance which simultaneously confers both possession and ownership upon the grantee cannot create a bailment, as an owner of goods cannot constitute himself their bailee at common law".

Traditional Registered Securities may be registered in the name of the global custodian (or its nominee) who will hold legal title. The question arises, are these arrangements compatible with a bailment? In Zivnostenska Banka National Corporation v. Frankman the shares which were the subject of the action were deposited with a bank and registered in the name of the bank's nominee. While the implications of the use of a nominee were not discussed, the arrangements did not affect the view that the deposit of shares with the bank constituted a bailment. "... [T]he relationship between the respondent and the appellants is that of bailor and bailee". However, it would be unsafe to conclude, on the above basis, that a bailment may arise where an owner of goods transfers legal title to goods to another. In Zivnostenska Banka the Law Lords did not take the point.

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428 For a discussion of whether an intangible is capable of possession, see chapter 2 section 2.
429 For a discussion of contractual limitation of implied fiduciary duty, see chapter 8 below.
432 Per Lord MacDermott, at 74.
objects." As discussed in chapter 3, the securities held in modern global custody are dematerialised (or immobilised, in global form or repackaged), and represented, not by physical certificates, but by entries in the books of the relevant intermediary. In the hands of the global custodian, such securities are intangible.

Chapter 2 above argued that intangible property is incapable of possession. Accordingly, it is "... improbable that the courts will develop the ... supposition that there may be a bailment of an intangible thing". It is almost universally agreed that no one can become a bailee without possession of a tangible chattel. The apparent incompatibility of intangibles with bailment, and their compatibility with trust, adds weight to the view that the global custodian may be a trustee.

c. Fungible Custody and Equivalent Redelivery

Global custodial arrangements in respect of securities are often fungible, in the following sense. The global custodian aggregates client holdings in a particular security into one commingled holding ("Client Holding"). In the case of securities held through a sub-custodian, the Client Holding will be represented in the books of the sub-custodian by an account in the name of the global custodian. In cases where a sub-custodian is not employed, the Client Holding in registrable securities will be registered in the name of the global custodian or its nominee, and the Client Holding in bearer securities (held through a clearing system in which the global custodian is a participant) will be held in an account in the name of the global custodian. While the global custodian's house position in any security will be segregated from the Client Holding, there will in general be no record of any allocation between clients in the books of the sub-custodian, in the relevant register of registrable securities or the books of the global depositary, as the case may be. The only note of the respective entitlements of the individual clients to the Client Holding will be in the books

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438 Swiss Bank Corporation v. Lloyds Bank Ltd. and Others. CA [1980] 2 All ER 419 per Buckley LJ 431.


440 Ibid p. 99. See also Dias, Jurisprudence, at 281: "A bailee is a person who gets possession of a chattel from another with his consent."
of the global custodian. This arrangement will be referred to as "Fungible Custody".\footnote{Reasons for Fungible Custody include economies of scale, administrative convenience and accounting facility.}

Thus, while it is possible at any time to determine how many of the individual securities comprised in the Client holding are attributable to a particular client, it is not possible to determine which ones.

A corollary of Fungible Custody is that the redelivery obligation owed by the global custodian to clients is not an obligation to return the securities originally deposited in specie, but merely an obligation to return securities equivalent to those originally deposited. The shares that a client receives (or delivers) out of global custody will almost certainly not be the same ones that it put in.

Case law indicates that the deposit of fungibles without a duty of segregation and without in specie redelivery rights may not be compatible with bailment. In \textit{South Australian Insurance Co Ltd v. Randell}\footnote{(1869) 6 Moo PCCNS 341.} it was held that an arrangement having these features was not a bailment.\footnote{In this case, corn was deposited by a farmer with a miller, to be stored and used as part of the miller's stock in trade. It was mixed with corn deposited by other farmers under the same terms with the miller. On delivery the farmer was given a receipt stating "received, etc. ... to store". Notwithstanding this, the miller was free to deal with the corn as its own property. The farmer had the right at any time to claim corn of like quality and quantity to that deposited, but could not claim back the original corn. The miller had the option, instead of delivering wheat, of paying the market price of such wheat at the time of demand. The stock was destroyed by fire and for insurance purposes it became necessary to determine whether the corn belonged to the miller beneficially. It was held that the transaction amounted to a sale by the farmer to the miller and was not a bailment of the corn; the corn was beneficially owned by the miller. "A bailment of trust implies, that there is reserved to the bailor the right to claim a re-delivery of the property deposited in bailment ... Whenever there is a delivery of property on a contract for an equivalent in money or some other valuable commodity, and not for the return of an identical subject-matter in its original or an altered form, this is a transfer of property for value - it is a sale, not a bailment. ... An incident of property, that is in bailment, is, that the bailor may require its restoration" (per Sir Joseph Napier at 358).} The case of \textit{USA v. Dollfas Mieg et Compagnie, S.A.}\footnote{HL (1952) 1 AC 582.} provides further evidence for the view that
Fungible Custody and equivalent redelivery are incompatible with bailment. This case indicates that where there is no segregation, there is no bailment and a creditor/debtor relationship arises.

These cases indicate that Fungible Custody is incompatible with bailment. However, conflicting authority is available in Harding v. Commr of Inland Revenue that, while traditionally bailment requires the in specie return of the

In this case the Bank of England held, for the governments of the USA, France and the UK, 64 numbered gold bars claimed to be the property of a French company. The bars had been wrongfully seized by the German authorities during the second world war and taken to Germany. After their recovery by allied forces they were lodged at the Bank of England by the three governments for safe custody pending their ultimate disposal. 13 bars were sold in error by the Bank. The company claimed, inter alia, redelivery of the bars. The action was allowed to proceed in respect of the 13 bars that had been sold, as in respect of them the bailment had been terminated. However, the action was stayed in respect of the others because the doctrine of sovereign immunity applied to claims for the recovery of property in the possession or control of a sovereign state. As bailors the three sovereign states were treated as being in possession or control of the 51 bars.

It was made clear obiter dicta in the judgments that segregation was considered to be necessary to establish a bailment. There was much discussion of whether the gold bars were effectively segregated. It was found that they were, although in error these arrangements for segregation had been breached when the 13 gold bars were sold. As for the other bars:

"These bars were held for the time being in specie to the order of [the three governments]" (per Lord Radcliffe, at 615). Bailment imposes a duty of segregation. "I have already stated my view that in regard to the 64 bars there was a contract of bailment and an obligation was thereby imposed on the bank to keep these bars separate and intact and not to allow them to become merged in the general pool of customers' gold ..." (per Earl Jowitt at 604).

"Ever since 1940 the Bank of England in operating a gold set-aside account had not kept separate the gold belonging to one customer from the gold belonging to another customer, though the customers' gold, considered globally, was kept separate from gold belonging to the Bank itself. Under the "gold set-aside" account ... the Bank on receiving gold ... from a customer would weigh the gold and assay it. Until the completion of weighing and assay the particular gold would be kept separate in the name of the depositor, but once these operations were completed, there would be recorded in the books of the bank the number of ounces of fine gold comprised in the deposit, and the depositor would be entitled to receive from the bank the number of ounces of fine gold so ascertained, less charges. The customer would, however, no longer be entitled to receive any particular bars of gold in satisfaction of his contract. The contract, in short, once weighing and assaying had been completed, created a relationship between the depositor and the bank closely resembling that of debtor and creditor, except that the Bank's obligation was to be discharged by the handing over of the requisite number of ounces of fine gold." per Earl Jowitt, at 598.

It was found that the gold bars in this case were segregated under a special arrangement. "If there had been no special arrangement ... [for segregation] ... I should have been of the opinion that the bailment of the individual bars had been terminated when the account was credited with the fine gold content." per Earl Jowitt, at 599.

[1977] 1 N.Z.L.R. 337 The case concerns an agreement relating to livestock.

"It seems to me that the transaction recorded in the agreement ... has the essential characteristics of a bailment while the document itself is in the nature of a bailment. According to its provisions the possession of the
goods originally deposited, "equivalent" redelivery obligations are compatible with bailment. See also Mercer v Craven\textsuperscript{448} Thus, there is some basis for arguing that, provided it can be shown that the parties intended that the client should retain a proprietary interest in the custody securities, the mere fact that the Bank's redelivery obligations are "equivalent" and not in specie may not itself defeat such intention. However, the prudent view seems to be that bailment requires in specie redelivery.

However, if the pooling of different clients' Custody Securities may be incompatible with bailment, it is not incompatible with trust. Provided that the custodian segregates the deposited assets from its own, a trust may be identified over the whole of the custody assets, of which the custody clients are equitable tenants in common. This idea will be developed in chapter 5 below.

d. \textit{Summary}

Several characteristics of the modern global custody product indicate a trust rather than a bailment. These are the passing of title, dematerialisation and Fungible Custody (with its corollary of equivalent redelivery).

The role of the custodian has evolved far beyond its traditional role as a bailee. The question arises, has it taken the law relating to bailment with it, so that bailment may now include transfer of legal title and relate to intangibles held in a pool? Or has it left bailment behind so that now the global custodian is a trustee?

Professor Palmer refers to the evolution of the law relating to hire purchase to illustrate the flexibility of the concept of bailment. "Indeed, hire-purchase

\textsuperscript{448} (19\textsuperscript{5}) 11 LQR 11-18.
affords a further example of the way in which bailment has adapted to modern circumstances. 449

This theme is picked up in a New Zealand judgment. "... [I]t would be a mistake to conclude that the transaction of bailment is one which has refused, and can still refuse, to undergo the evolution and adaptation which the common law imposes upon every legal institution; and although the bailments known to Roman Law were sufficient for Lord Holt C.J. in 1703, I decline to assume that, under the pressures and stresses of modern legal necessity, some new mutation may not have burst into flower, of a quality to startle the author of the Institutes were he privileged to behold it ..."450

However, in the absence of direct judicial authority, it would be prudent to assume that the law is today what it was yesterday, and that the global custodian, by moving into the late 20th century, has moved into a new legal category, and is a trustee.451

f. custodian trustees

Global custodians who are trustees should not be confused with custodian trustees for the purposes of section 4(3) of the Trustee Act 1907. Statutory custodian trustees hold trust property while leaving the administration and management of the trust to managing trustees. Custodian trustees may be appointed in connection with a debenture issue.

449 Palmer, Bailment, p. 6.
451 The bailment analysis will still, of course, be available where physical instruments are held on a segregated basis.
Chapter 5. The Allocation Problem

A. Identity in Securities

Individual Physical Bearer Securities may be distinguished one from the other, because each has inherent identity derived from the physical instrument that constitutes it. In contrast, registered securities (whether Traditional Registered Securities or Computerised Registered Securities) have no inherent individual identity, as they represent an unallocated fraction of the property represented by the whole issue of which they form part. Chapter 3 argued that computerisation has the effect in practice of transforming bearer securities into registered securities, so that the computerisation of securities involves the loss of their individual identity. One computerised security within an issue is undifferentiated from another.

Recent case law has caused some concern in London among custodians and their clients, and prompted a debate in the legal community about what will be referred to in this work as "the Allocation Problem". This arises where there is Fungible Custody. The Allocation Problem is the possible legal difficulty in asserting proprietary rights over assets forming part of the commingled pool, when one cannot identify which particular assets within the pool are subject to such proprietary rights.

This chapter will argue that the Allocation Problem is governed by different lines of cases, raising different principles, depending on whether the securities in question are Physical Bearer Securities or registered securities. Each will be considered in turn. Common sense would suggest that want of allocation should not defeat property rights in circumstances where allocation is jurisprudentially impossible (i.e. within a holding of registered securities). This conclusion will be reached in section E. However, it will also be argued that the type of property right that arises by operation of law in such circumstances may not be an interest under a trust, and this chapter will therefore argue

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453 i.e. bearer securities in the form of physical instruments. See chapter 3.
454 i.e. registered securities not in computerised form. See chapter 3.
455 i.e. registered securities in computerised form. See chapter 3.
456 This term was defined in chapter 4 to mean, broadly, the commingling of the assets of different clients in a pool.
that it is desirable (in the case of all securities in Fungible Custody) to address the allocation problem by express language providing for equitable co-ownership of the securities by the custody clients.

B. The Allocation Problem

1. Loss of Property Risk

The Allocation Problem concerns "... the law's insistence that proprietary rights cannot be acquired in fungibles forming an unidentified part of a bulk until they have been separated by some suitable act of appropriation". This arises both at law and in equity. The common law rule is well established in case law concerning the sale of goods, and is given statutory force in section 16 of the Sale of Goods Act 1979. The rule in equity is based on the principle that a trust cannot be validly established without certainty of subject matter. Accordingly, a trust cannot be created by the legal owner of a commingled pool of assets who purports to transfer to a beneficiary equitable title of an unallocated portion of that pool.

Because, in Fungible Custody, the Custody Securities of respective clients are not individually identifiable, some commentators have argued that the rights of clients may be confined (broadly) to a contractual right against the custodian, arising under the custody agreement, to call for redelivery of securities.


459 This provides as follows: "Subject to section 20A below, where there is a contract for the sale of unascertained goods no property in the goods is transferred to the buyer unless and until the goods are ascertained."

Section 20(A) (inserted by the Sale of Goods (Amendment) Act 1995 s1(1) in response to Law Commission paper No. 215) provides for title in ex-bulk goods to pass under a tenancy in common, where the purchase price has been paid.

The rule relates to goods, and securities are not goods but (generally) choses in action. Goods are defined in Section 61(1) of the Sale of Goods Act exclude things in action.

460 Knight v Knight (1840) 3 Beav 148

461 See In re Wait [1927] 1 Ch 606
equivalent to those deposited\textsuperscript{462}. The client's relationship with the custodian in respect of securities may be that of debtor and creditor (in the broad sense of obligee and obligor). The risk that clients' rights in this respect may be merely contractual will be called, "Loss of Property Risk".

The implications are serious, both for the clients and for the custodian.

a.  \textit{Credit Risk of Custodian}

If the clients have proprietary rights in the Custody Securities, those assets will not be available to the general creditors of the custodian in the event of the custodian's insolvency, or to judgment creditors of the custodian. However, if the clients' rights are merely contractual, the Custody Securities will be so available and the clients will rank as unsecured creditors. In short, clients will take the credit risk of the custodian.

b.  \textit{Other Risks}

An important factor contributing to the growth of global custody in the 1980s was the perception that it is a low risk business for the custodian. This perception is reflected in the capital adequacy treatment of custody, whereby client assets do not attract a capital weighting. There are in fact many risks associated with the holding of assets in global custody. These are discussed in the International Society of Securities Administrators' \textit{Report on Global Custody Risks}\textsuperscript{463}. One should therefore ask why

\textsuperscript{462} In an article published in 1987 (R.M. Goode, \textit{Ownership and Obligation in Commercial Transactions}, (1987) 103 LQR, 433), Professor Goode considers the implication of the principle for immobilised securities held in fungible accounts with clearing firms such as Euroclear and Cedel. This argument was developed in an article by Robert Ryan and applied to investments held fungibly by global custodians. (Robert Ryan, \textit{Taking Security Over Investment Portfolios held in Global Custody} [1990] 10 JIBL 404).

\textsuperscript{463} ISSA, \textit{Symposium Report}, 6, May 1992. Among the risks identified in the ISSA Report are:-

- \textit{country risk}, or risk connected with holding assets in a foreign country, e.g. political, economic, fiscal and legal changes, or gaps in supervisory coverage;
- \textit{counterparty risk}, or risk of non-fulfilment of a trade contract due to inability or unwillingness.
- \textit{credit risk}, or risk that a counterparty will fail to deliver or pay in full on due date or be liquidated or go bankrupt;
- \textit{liquidity risk}, or risk that settlement of an obligation will not be made on due date, but on some unspecified date thereafter;
custodians (and their regulators) treat custody as a low-risk business. It is because they assume that the above risks are in general borne, not by the custodian, but by its client. This assumption is based on the further assumption that the custody securities belong to the client, for "If I own goods, I bear the burden of accidental loss or damage".\(^{464} \)\(^{465} \) On the basis that the custodian is a trustee, the above risks are borne by the client, subject only to the custodian's duty of care under the general law.\(^{466} \) Thus, if the custody portfolio suffers a loss which is not attributable to the fault of the custodian, the custodian is not obliged to make good the loss.

If, however, the custody securities do not belong to the client, and if therefore the custodian is not a trustee but a debtor, the general law will not reduce the custodian's redelivery obligation to one of proper care. Under the general law, the duty of trustees is to take the proper level of care, while the duty of debtors is strict. The redelivery obligation of the custodian will therefore be strict (and apply whether or not the securities in question are available to the custodian in the custody portfolio) unless there is effective contractual provision to the contrary. In other words, the global custodian may bear all the risks whereby custody securities may become unavailable for redelivery, unless the provisions in the global custody agreement, which limit its liability, are effective.

The effectiveness of exclusion clauses is discussed in Chapter 8.

c. Taxation

\begin{itemize}
\item \textit{Market risk}, or risk arising from market price fluctuation of securities and currencies during the settlement interval;
\item \textit{Operational risk}, or risk of loss due to clerical errors, organisational deficiency, delays, fraud, system failure, default by third party service providers and similar incidents;
\item \textit{Settlement risk}, or risk that a party will default on settlement or payment obligations;
\item \textit{Systemic risk}, or risk that the inability of one institution to meet its obligations when due will cause other participants to be able to meet their obligations when due; and
\item \textit{Transfer risk}, or risk that a country will introduce exchange controls.
\end{itemize}


\(^{465}\) This is subject to contractual provision to the contrary; see chapter 8 below.

\(^{466}\) See chapter 8 for a discussion of the level of this duty.
If the delivery of securities by the client to the custodian involves transferring property in those securities to the custodian, and if the redelivery of securities to the client at the end of the custody arrangement involves transferring property in those securities to the client (or to its order) both steps may be treated as a disposal for taxation purposes giving rise to a potential liability for capital gains tax and, in respect of certain securities, a liability to tax under the accrued income scheme or similar legislation. Furthermore, if the entire property interest passes to the custodian, so too will the entitlement to underlying tax credits, leaving the custodian potentially in the position of a dividend manufacturer and potentially prejudicing the availability of treaty reliefs. The stamp duty implications of such transfers would also need to be reviewed if they involved a change in the beneficial ownership of the securities concerned. In short, if the rights of clients are merely contractual, the global custody product may be taxable in a manner akin to a repurchase program.

d. Charging Custody Securities

If the client has no proprietary rights in the custody securities, he cannot charge those securities (whether in favour of the custodian or a third party). It has been suggested\(^467\), however, that a charge may be given over the client's contractual rights against the custodian under the custody agreement. The value of such security to any third party will depend upon the credit risk of the custodian. Thus, the value of portfolios of securities held in custody as collateral for borrowing will be reduced, as it will be subject to the credit risk of the custodian as well as that of the issuer.

It is therefore important to address the Allocation Problem (and therefore Loss of Property Risk) in the context of custody.

2. The Cases

Debate about the Allocation Problem has focused on the following line of cases.

a. Re London Wine (Shippers) Ltd. 468

This case concerned a wine importing company to which a receiver had been appointed pursuant to a floating charge in favour of a bank. The company held wine in various warehouses. Most of the wine had been sold to individuals who left the wine in the possession of the company's warehouse agent. There was no segregation of any wine crates or cases in favour of any particular individual. The individuals claimed that they had a proprietary interest in the relevant crates or cases of wine. The receiver argued that they had merely unsecured claims for delivery of wine against the company.

Judgment was given in favour of the receiver, on the basis that the individuals did not have any proprietary interests in the wine because there had been no allocation; proprietary rights could not pass at law for want of allocation or in equity for want of certainty of subject matter.

Similar issues arose in the case of Hunter v Moss, 469 in which it was held that lack of allocation did not prevent property from passing. However this case concerned shares, and the decision was based on the nature of shares. It is therefore not relevant to all types of security. This case will be discussed in the section on registered securities below (section E).

b. In re Stapylton Fletcher Ltd. 470

The facts of this case were similar to those of Re London Wine, except that the wine intended for customers was segregated from the trading stock of the company. This difference was held by Judge Paul Baker Q.C. to be crucial: "I do not regard that decision [in Re London Wine] as inevitably governing the case before me. One obvious difference in the present case is the segregation of the wine purchased by the customers in a separate part of the warehouse and the careful maintenance of records within the company. Further as the London Wine Company was free to sell its stock and satisfy the customers from any

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468 (1986) PCC 121

469 [1993] 1 WLR 934.

470 In re Stapylton Fletcher Ltd., In re Ellis, son & Vidler Ltd., [1944] 1 WLR 1181.
other available source, there was no ascertainable bulk in that case.\textsuperscript{471} On this basis judgment was given in favour of the claimants from the liquidators. "In summary, on the facts here, I conclude that if a number of cases or bottles of identical wine are held, not mingled with the trading stock, in store for a group of customers, those cases or bottles will be ascertained for the purposes of section 16 of the Sale of Goods Act 1979 even though they are not immediately appropriated to each individual customer. Property will pass by common intention and not pursuant to section 18 rule (5). They will take as tenants in common.\textsuperscript{472}

As custodians segregate their house positions from Client Holdings, it might be thought that Fungible Custody can benefit from the rule in \textit{Stapylton Fletcher}. However, the Allocation Problem concerns want of certainty of subject matter for an equitable interest to arise, and the case (unlike \textit{Re London Wine}) related only to legal interests arising in the sale of goods.\textsuperscript{473} A later case, \textit{Re Goldcorp}, considered both equity and law.

c. \textbf{Re Goldcorp Exchange Ltd. (in receivership)\textsuperscript{474}}

Goldcorp, a dealer in precious metals, agreed with certain customers to sell gold to them and hold it for them on an unallocated basis. It represented that it would set aside and hold a pool of gold sufficient to meet the claims of unallocated customers, but did not do so. It became insolvent and its stock of gold was insufficient to meet unallocated customers' claims. In a dispute between receivers appointed pursuant to a floating charge and unallocated customers, judgment was given (reversing the decision of the New Zealand Court of Appeal reported in \textit{Liggett v Kensington}) in favour of the receivers. The claims of the unallocated customers were merely contractual.

\textsuperscript{471} at 1194

\textsuperscript{472} at 1200.

\textsuperscript{473} "As I have found for the first four claimants in the case relating to E.S.V. on the basis of the passing of property at law, I do not have to consider the alternative lines of argument based on trusts, fiduciary relationships or other equitable principles in relation to these claims." (at 1201).

\textsuperscript{474} [1994] 2 All ER 806
This decision would seem to support the authority of *Re London Wine*. Indeed it was in part based on that earlier case.475

However, on a closer reading, the judgment provides authority that Fungible Custody is not affected by the Allocation Problem, and is not caught by the principle in *Re London Wine*, because custodians do segregate their house positions from Client Holdings. Lord Mustill distinguishes (‘generic goods’ the source of which is not specified) from ‘ex-bulk’ goods (which must come from a specified source).476 The case for the claimants failed (both at law and in equity) because on the facts *Goldcorp* was an example of generic goods.477 If it had been a question of ex-bulk goods, the position would have been different.478

475 “The facts of that case were not precisely the same as the present, and the arguments on the present appeal have been more far-reaching than were there deployed. Nevertheless their Lordships are greatly fortified in their opinion by the close analysis of the authorities and the principles by Oliver J. and in other circumstances their Lordships would have been content to do little more than summarise it and express their entire agreement.” per Lord Mustill at 823.

476 “It is common ground that the contracts in question were for the sale of unascertained goods. For present purposes, Two species of unascertained goods may be distinguished. First, there are ‘generic goods’. These are sold on terms which preserve the seller’s freedom to decide for himself how and from what source he will obtain goods answering the contractual description. Secondly, there are ‘goods sold ex-bulk’. By this expression their Lordships denote goods which are by express stipulation to be supplied from a fixed and a pre-determined source, from within which the seller may make his own choice... but outside which he may not go. For example, ‘I sell you 60 of the 100 sheep now on my farm’. ” at 814.

477 “...In fact, however, the case turns not on appropriation but on ascertainment, and on the latter the law has never been in doubt. It makes no difference what the parties intended if what they intend is impossible: as is the case with an immediate transfer of title to goods whose identity is not yet known. ...Their Lordships have laboured this point, about which there has been no dispute, simply to show that any attempt by the non-allocated claimants to assert that a legal title passed by virtue of the sale would have been defeated, not by some and legal technicality but by what Lord Blackburn [in Treatise on the Effect of the Contract of Sale called ‘the very nature of things’. The same conclusion applies, and for the same reason, to any argument that a title in equity was created by the sale, taken in isolation from the collateral promise.” at 814.

478 “Their Lordships therefore turn to consider whether there is anything in the collateral promises which enables the customers to overcome the practical objections to an immediate transfer of title. The most direct route would be to treat the collateral promises as containing a declaration of trust by the company in favour of the customer. The question then immediately arises: what was the subject matter of the trust. Their Lordships do not doubt that the vendor of goods sold ex-bulk can effectively declare himself trustee of the bulk in favour of the buyer, so as to confer pro tanto an equitable title. But the present transaction was not of this type.” (at 815.) Because there was no segregation of the clients’ entitlement from the trading stock of the company, the court could not infer an intention that the commingled assets should be held on trust for clients. If there had been such segregation, it might have done so.

See also the following passage: “The only remaining alternative, consistently with the scheme being designed to give the customer any title at all before delivery, is that the company through the medium of the collateral promises had declared itself a trustee of the constantly changing undifferentiated bulk of bullion which should
However, the position remains unclear. Nowhere is it categorically stated that if client and house assets had been segregated, the interest of unallocated clients would have been proprietary; it is merely indicated that they might have been. 479 As Cooke P understated in the court below, "...it is a difficult area of law". 480

Because of the seriousness of Loss of Property Risk, the prudent view would be to assume that it is present.

As indicated in section A above, when considering the relevance of the Allocation Problem for Fungible Custody, the position differs according to whether the securities held in Fungible Custody are Physical Bearer Securities, or registered securities. Although Physical Bearer Securities are inherently capable of allocation, in Fungible Custody they are unallocated. In contrast, section E below will argue that the inherent fungibility of registered securities provides an answer to the Allocation Problem that is unavailable to Physical Bearer Securities.

C. Physical Bearer Securities

have been set aside to back the customers' contracts. Such a trust might well be feasible in theory, but their Lordships find it hard to reconcile with the practicalities of the scheme, for it would seem to involve that the separated bulk would become the source from which alone the sale contracts were to be supplied: whereas, as already observed, it is impossible to read the collateral promises as creating a sale ex-bulk. ...Let it be assumed, however, as did McKay J in his dissenting judgment, that the creation of a separate and sufficient stock would have given the non-allocated purchasers some kind of proprietary interest, the fact remains that the separate and sufficient stock did not exist." at 820.

479 Lord Mustill considers Re Wait [1927] 1 Ch 606 at pp 814, 815 of his judgment. In that case, W. bought 1,000 tons of wheat to be shipped from Oregon. He subsold 500 tons to the claimants, who paid in full. It was shipped but before it arrived W. went bankrupt. His trustee argued the claimants' rights were merely contractual. It was held by the majority in the Court of Appeal that to 500 tons due to the claimants had not been appropriated, so no proprietary interest passed. However the court was divided and Sargant L.J. argued in his dissenting judgment that the claimants had an equitable assignment of part enforceable against the whole.

In Goldcorp, Lord Mustill comments, "It is unnecessary to examine in detail the decision of the Court of Appeal in Re Wait [1927] 1 Ch 606...for the facts were crucially different. There, the contract was for a sale ex-bulk. ...It was this feature which prompted the dissenting opinion of Sargant L.J. that the sub-purchasers had a sufficient partial equitable interest in the whole to found a claim for the measuring out and delivery of 500 tons. No such feature exists here." In this way, he indicates that ex-bulk provision would have permitted such an argument as that of Sargant L.J in Re Wait. On the other hand, he then goes on to refer to judgment of Atkin L.J in same case, indicating no title can pass even in ex-bulk provision.

480 Liggett v Kensington [1993] 1 NZLR 257 at 268.
In the case of Physical Bearer Securities, the Allocation Problem can be reduced (but not eliminated) on the basis of timing, as follows.

1. **Timing**

   a. *two lines of cases*

   The issue under consideration in *Re London Wine* was the acquisition, by the purchasers, of proprietary interests in assets forming part a fungible pool. The key cases discussed in the judgment relate to the sale of goods transactions in which the same issue arose, i.e. whether property can be effectively transferred in respect of an unallocated portion of a pool. The important point is that in all these cases the mixing of the whole antedates the possible ownership of part.

   In one case that was discussed, the mixing of the whole predates the ownership of part, and this case is clearly distinguished by Oliver J. "The cases principally relied on in support of [the submission that the buyers own the wine as tenants in common] were *Spence v. Union Marine Insurance* ..., and *Inglis v. Stock* ... The former is of little help because it was concerned with a *wholly different question* [the author's italics], namely, what is the result when specific goods which undoubtedly were in separate individual ownership to start with became so mixed as to be indistinguishable".\(^{481}\) The "wholly different question" is the preservation of existing proprietary rights, as opposed to the creation of new ones.

   English case law makes a clear distinction between two situations. The first is where there is a purported transfer of an unidentified part of a fungible bulk without appropriation. The second is where property belonging to several persons is commingled into a fungible bulk without segregation (commingling). In the former, *Re London Wine* and *Goldcorp* indicate that new proprietary rights do not arise, whether in law or equity, and this is the Allocation Problem. In the latter, the position is different.

\(^{481}\) at 136.
b. **Commingling**

There is a long line of authority establishing the principle, based on Roman law, that where the goods of different owners are mixed together so that they cannot be separated, the owners will hold the commingled goods as tenants in common. These cases concern accidental or wrongful commingling; the parties have not intended it or agreed upon its outcome. These decisions, and those that informed them, were made

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482 The Latin term for commingling is *confusio*: "Confusio is the Latin word for the mixing of goods belonging to two different owners, so that they cannot be separated". Per Staughton J., *Indian Oil Corp Ltd v Greenstone Shipping S.A., the Ypatianna*, [1987] 3 All ER 893 at 894.

483 In the case of *Buckley v Gross* ((1863) 3 B&S 566, 122 ER 213), tallow belonging to different persons melted and flowed together into the sewers. It was held that the original owners did not lose their property in the mixture. "The tallow of the different owners was indeed mixed up into a molten mass, so that it might be difficult to apportion it among them; but I dissent from the doctrine that, because the property of different persons is confused together, that entitles a third person to steal it with impunity. Probably the legal effect of such a mixture would be to make the owners tenants in common in equal proportions of the mass, but at all events they do not lose their property in it." (per Blackburn J. at 574-575.)

In the case of *Spence v. Union Marine Insurance Co. Ltd.* ((1868) LR 3 CP 427 a ship's cargo consisting of bales of cotton, was shipped for various consignees. The ship was lost at sea. Some of the bales were delivered to the appropriate consignees; some were lost and some were recovered but had become indistinguishable by the obliteration of the marks on them; this last category was sold. The plaintiffs had a consignment of which only a small proportion was received in an identifiable state. The price of cotton having fallen, the plaintiffs wished to argue that the remainder of their consignment should be treated as having been lost outright so that they could claim for total loss (and not merely average loss) under their policy of insurance. It was held that there had been no actual or constructive total loss. "... when goods of different owners become by accident so mixed together as to be undistinguishable, the owners of the goods so mixed become tenants in common of the whole in the proportions which they have severally contributed to it". (per Bovill, C.J., at 437.)

In the case of *The Ypatianna*, the owner's vessel was chartered for the carriage of a cargo of crude oil from the Soviet Union to India. At the time the cargo was loaded, the vessel was carrying a residue of Iranian crude oil left over from its previous voyage and the cargo of Soviet crude was mixed with the residue without the consent of the consignees. There was no evidence that the two were of different qualities. After unloading at Madras some oil remained on board. The consignees claimed that this oil had become their property. Before this case, there was a line of authority that English law differed from Roman law in the case of the wrongful co-mixing of property. Under English law, where one party mixed his property with the property of another, so that they became indistinguishable, and did so wrongfully without the other person's consent, the innocent party became the owner of the whole (Lupton v White (1808) 15 Ves 432.) Indian Oil Corp substituted "... the rule which justice requires. This is that where B wrongfully mixes the goods of A with goods of his own which are substantially of the same nature and quality, and they cannot in practice be separated, the mixture is held in common and A is entitled to receive out of it a quantity equal to that of his goods which went into the mixture, any doubt as to that quantity being resolved in favour of A". (per Staughton J. at 907, 908.)

Thus, the only difference between the rules applicable to accidental co-mixing and wrongful co-mixing is that in the latter, any doubt as to quantity is resolved in favour of the innocent party.
not upon the notion, that strict justice was done, but upon this: that it was the only justice, that could be done".484

The question arises, can the same principle be applied to circumstances where the property of several persons is mixed by the agreement of those persons (for example under the express or implied terms of a custody agreement)? The answer will depend upon the intention of the parties in each case. In the case of Coleman v. Harvey485 Cooke P refers to the judgment of Staughton J in Indian Oil Corp, and comments, "In my opinion the same should apply to a consensual [mixing] such as occurred in this case, at least where the evidence does not point to an intention to part altogether with ownership from the start".486 Thus, where it is possible to show that the parties who have agreed to mix their property together, intend that their proprietary rights should not be thereby extinguished, it should also be possible to identify a tenancy in common.

(c) Old and New Custody Securities

This principle applies to Fungible Custody as follows. Those custody securities that were transferred to the custodian at the initiation of the custody relationship will be referred to as "the Old Custody Securities". In the case of Old Custody Securities, the client’s proprietary interest is not extinguished, but continues as an interest in an equitable tenancy in common.

However, this may not be true of securities purchased by the client and transferred to the custodian during the currency of the custody service ("New Custody Securities"). Where the custodian is instructed by a client (client 1) to settle a purchase transaction of 50 bonds on its behalf, the manner in which the custodian delivers those bonds into the client’s

484 per Staughton, J., quoting from the judgment in White v Lady Lincoln, The Duke of Newcastle v Kinderley (1803) 8 Ves 363, 32 ER 395, in Indian Oil Corp, at 902.

485 (1989) 1 NZLR 723.

486 See also Judge Paul baker Q.C. in In re Stapylton Fletcher [1994] 1 W.L.R. 1181 at 1199: "So one may use the tenancy in common as a tool for remedying an unforeseen mixing, damage or loss. If the creation of a tenancy in common can be brought about by the construction of law, it can equally be brought about by agreement either express or to be inferred from the circumstances."
custody account may be as follows. If the counterparty employs a broker (acting as principal) who also acts for another client of the global custodian, (client 2) and if client 2 purchases bonds on the same day through the same broker, the broker may aggregate the orders, or the global custodian may aggregate the settlement of the bonds of clients 1 and 2, so that one transfer of bonds into the client holding may satisfy both of them.

In such a case it is not possible to identify the particular bonds to which the transaction relates. Such identification would only be possible if the delivery obligation was satisfied by a transfer into the Client Holding of 50 bonds (and perhaps only if no other such transfer took place on the same business day). This may be unlikely in practice. Because it may not, in practice, be possible to identify such securities before they enter the pool of the Clients Holding, it may not be possible to argue that the holding of them is an example of commingling. Therefore it would be prudent to assume that the Allocation Problem may be relevant to the Fungible Custody of Physical Bearer Securities.

2. Tenancy in Common

However it is possible to address Loss of Property Risk by appropriate wording in the custody documentation expressly creating a tenancy in common.

The natural answer to the Allocation Problem is co-ownership. Rather than seek to identify a trust in favour of each client over their unallocated portion of the Client Securities, one may identify one global trust over all the Client Securities of a particular type in favour of all relevant clients as tenants in common.

487 Another possibility is "internal settlement", where one client of the global custodian sells securities to another such client. "Internal settlement. A settlement that is effected through transfers of securities and funds on the books of a single intermediary. An internal settlement requires both counterparties to maintain their securities and funds accounts with the same intermediary" Bank for International Settlements, Cross-Border Securities Settlement, Basle, May 1995, Glossary.
It was shown (in section 1.6 above) that such equitable tenancies in common probably arise by operation of law in cases of confusio or commingling, in relation to Old Securities, so that pre-existing proprietary rights are not extinguished by Fungible Custody. However, it was also noted that such co-ownership arrangements do not arise by operation of law where it is sought to create new proprietary rights over part of a pool. (The position differs in New York where, under the Uniform Commercial Code, co-ownership is implied in such circumstances.)

The judgment in Re London Wine indicates that, in these circumstances, while a tenancy in common will not arise by operation of law, it may be established by clear express provision.

The prudent course would therefore be to include very clear express wording in the custody documentation to create such equitable tenancies in common among the custody clients over the commingled Client Holdings.

The structure of these equitable tenancies in common is comparable to the structure of a unit trust. Each client will have an interest in an undivided

488 See the comments of Mustill J in Karlshamns Oljefabriker v Eastport Navigation Corporation [1982] 1 All E.R. 208 at 214, quoted by Judge Paul Baker Q.C. in In re Stapylton Fletcher at 1197 in the following passage: "The passing of property is concerned with the creation of rights in rem, which the purchaser can assert, not only against the vendor but against the world at large, and which he can alienate in such a way as to create similar rights in a transferee. Where there are multiple contracts of sale in the hands of different buyers, in relation to undivided bulk, there are only two possible solutions. First, to hold that the buyers take as joint owners in undivided shares. English law has rejected this solution. The only alternative is to hold that the property does not pass until the goods are not only physically separated but separated in a way which enables an individual buyer to say that a particular portion has become his property under the contract of sale..." And see also Re Goldcorp Exchange Ltd at 820.

489 Section 8-313. See Judge Paul Baker Q.C. in In re Stapylton Fletcher at 1197, "The reference to English law as rejecting the solution of undivided shares is a reminder that in the United States of America that solution has been adopted."

490 "I cannot see how, for instance, a farmer who declares himself to be a trustee of two sheep (without identifying them) can be said to have created a perfect and complete trust whatever right he may confer by such declaration as a matter of contract. And it would seem to me to be immaterial that at the time he had a flock of sheep out of which he could satisfy the interest. Of course, he could by appropriate words, declare himself to be a trustee of a specified proportion of his whole flock and thus create an equitable tenancy in common between himself and the named beneficiary, so that a proprietary interest would arise in the beneficiary in an undivided share of the flock and its produce. But the mere declaration that a given number of animals would be held upon trust could not, I should have thought, without very clear words pointing to such an intention, result in the creation of an interest in common in the proportion which that number bears to the number of the whole at the time of the declaration." Oliver J at 137.
portion of the securities comprised in the tenancy in common equal to that which the number of such securities credited to their account in the global custodian's books bears to the total number of such securities in the client position.

A separate tenancy in common exists in relation to each type of security from time to time comprised in clients' portfolios. This is because, in practice, it will not be the case that each client's portfolio includes the same range of securities in the same proportions. A necessary feature of a tenancy in common is unity of possession. 491 "Unity of possession is common to all forms of co-ownership. Each co-owner is as much entitled to possession of any part of the [property] as the others". 492

This multiplication of tenancies in common should not create any administrative difficulty, because their existence is notional and automatic, and does not require any practical step to be taken.

Chapter 3 considered the effect of computerisation on securities, and concluded that Immobilised, Global and Repackaged Securities (together Intermediate Securities) were interests under equitable tenancies in common. The holding of securities in Fungible Custody introduces another such level of intermediation, through which the interest of the investor is equitable and co-owned.

In conclusion, the natural solution to the Allocation Problem is the equitable co-ownership of the Client Securities by the clients under tenancies in common. The case law indicates that such arrangements may not arise by operation of law, at least in respect of New Securities. It is possible that (because the historical role of the custodian, the current market perception of that role and the taxation and regulatory treatment of global custody all indicate an intention that client property in custody assets should be preserved) the Courts would hold that tenancies in common do so arise. The likelihood that the Courts would not so hold may be considered remote. However, the impact of such an event would be serious. Therefore, in the absence of direct authority for


tenancies in common arising over New Securities by operation of law, it would be prudent to establish such equitable co-ownership arrangements by clear express wording. This wording could be included in the custody contract, or even behind the scenes in a deed poll executed by the custodian.

D. Registered Securities

1. The impossibility of Allocation

Unlike registered securities, Physical Bearer Securities are constituted by paper instruments which are choses in possession. These instruments confer upon each holder a chose in action against the issuer (usually a debt). This chose in action differs from the chose in action constituting a registered security, for it is complete, in the sense that it is the whole of the benefit of a separate covenant to pay. In contrast, the interest of the owner of a registered security is fractional, in the sense that it is an undivided share of the obligations of the issuer in respect of the entire issue of securities.

Because they are undivided, individual registered securities are incapable of allocation within a holding of such securities.

2. Old Securities

It was shown in section D.1 above that, in the case of Physical Bearer Securities, the Old Securities are protected by the commingling rule, under which tenancies in common arise by operation of law. The position for registered securities is slightly different, for they are undivided. When Old Physical Bearers Securities are placed in Fungible Custody, they are mixed; when Old registered securities are placed in Fungible Custody, they are both mixed and unified, because the Client Holding of the custodian or its nominee of registered securities is undivided. It is arguable that the confusio cases cover

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493 This is the approach taken by London Settlement Systems in addressing the same legal problem arising when securities are pooled in the course of settlement. See the Talisman Clearing House Regulations, Regulation E.5.13.a and the Central Gilts Office Reference Manual Section 8.2.8.

494 See chapter 3 section 4.A

495 See Chapter 3 section C.2.f
both situations.\textsuperscript{496} However, the position is unclear as all of the commingling cases relate to tangible goods which, although mixed, are legally capable of division.

A body of case law that applies more naturally to these circumstances is that concerning the equitable rules of tracing.\textsuperscript{497} These rules concern ex-bulk interests in undivided property (including bank accounts).\textsuperscript{498} These were discussed briefly in chapter 2 section 3.c and further in chapter 3 section 7.B.d. Although the tracing rules are most commonly called into play as a remedy, in order to recover trust assets which have been misappropriated in breach of trust, they also apply in the absence of breach of trust, as a means of determining trust property.\textsuperscript{499} Accordingly, where Fungible Custody takes place, tracing should be available even though the client agreed to those arrangements.

In the case of \textit{Re Hallett's Estate}\textsuperscript{500} Sir George Jessel states that where money which is owned in equity by one person is mixed together with other money, equity will impose a charge on the "indistinguishable mass"\textsuperscript{501} in the hands of the trustee or third parties. Thus, the equitable interest under a trust becomes an equitable interest under a charge, when it is mixed in an indistinguishable mass. This conversion from one type of equitable interest to another\textsuperscript{502} upon commingling is natural. An interest under a trust is a species of title, while a charge is merely an encumbrance. While a trust requires certainty of subject

\textsuperscript{496} See, for example, \textit{Buckley v Gross} (1836) 3 B & S 566 per Blackburn J at 575.


\textsuperscript{498} "... this is the case of a banking account where all the sums paid in from one blended fund, the parts of which have no longer any distinct existence..." \textit{Claytons Case}, per Sir Wm Grant MR at 798.

\textsuperscript{499} "There is no distinction therefore between a rightful and a wrongful disposition of the property, so far as regards the right of the beneficial owner to follow the proceeds" \textit{Re Hallett's Estate} per Jessell M.R. at 708. Although for nearly a century after \textit{Re Hallett's Estate} all tracing cases involved a tracing claim to the proceeds of unauthorised dispositions, the ability of beneficial owners to trace proceeds of authorised sales was confirmed in \textit{Aluminium Industrie Vasssen B.V. v Romalpa Aluminium} [1976] 1 Lloyd’s Rep 443.

\textsuperscript{500} \textit{Knatchbull v Hallett} [1874 - 80] All ER 793

\textsuperscript{501} at 801.

\textsuperscript{502} A charge is always equitable and cannot subsist at law: "Since a charge is a mere encumbrance and does not involve any conveyance or assignment at law, it can exist only in equity or by statute." R.M. Goode, \textit{Commercial Law}, p. 646.
matter, it is in the nature of a charge to attach to an asset without necessarily exhausting it, so that the question of which part of the asset is impressed with the charge, does not arise.\textsuperscript{503} Professor Hayton refers to "...fundamental law underlying equitable tracing principles: that, as \textit{Re Diplock} [1948] Ch 465 shows, even where there is at the outset a clear trust of a separate £X, that trust of £X ceases to exist once wrongfully mixed with the trustee's, or an innocent volunteer's own £Y, so that to disentangle matters the beneficiaries then have a charge over the £(X + Y) fund or its product for £X and interest or, if the £(X + Y) had been profitably invested, a share of each investment in the proportion X to X + Y."\textsuperscript{504}

The scope of the tracing charge has been the subject of much judicial discussion. The largest claims were made for it in the case of \textit{Space Investments}.\textsuperscript{505} It was opined that the tracing charge attaches to all the assets of the trustee, on the basis that those assets have been swollen by the trust assets the subject of the tracing claim.\textsuperscript{506}

However, this "swollen assets" approach was criticised by commentators\textsuperscript{507} and judicially in \textit{Re Goldcorp Exchange Ltd} (in receivership).\textsuperscript{508} Lord Mustill\textsuperscript{509} quotes Court of Appeal in \textit{Re Diplock's Estate},\textsuperscript{510} as follows: "The equitable remedies presuppose the continued existence of the money either as a separate

\textsuperscript{503} For a discussion of the nature of a charge, see \textit{Swiss Bank Corporation v Lloyds Bank} [1980] 2 All ER 419 at 426.

\textsuperscript{504} \textit{Uncertainty of Subject-Matter of Trusts}, (1994) 110 LQR 335.

\textsuperscript{505} \textit{Space Investments v Canadian Imperial Bank} [1986] 3 All ER 75

\textsuperscript{506} Lord Templeman said, obiter, that where a bank trustee in breach of trust treats trust moneys as if they had been placed on deposit with it, "In these circumstances it is impossible for the beneficiaries interested in trust moneys misappropriated from their trust to trace their money to any particular asset belonging to the trustee bank. But equity allows the beneficiaries...to trace the trust money to all the assets of the bank and to recover the trust money by the exercise of an equitable charge over all the assets of the bank. Where an insolvent bank goes into liquidation that equitable charge secures for the beneficiaries and the trust priority over the claims of the customers in respect of their deposits and over the claims of all other unsecured creditors." at 76, 77.


\textsuperscript{508} [1994] 2 All ER 806, at 831, 832.

\textsuperscript{509} at 831

\textsuperscript{510} [1948] Ch 465 at 521
fund or as part of a mixed fund or as latent in property acquired by means of such a fund. If, on the facts of any individual case, such continued existence is not established, equity is as helpless as the common law itself. " Because of this, there can be no tracing through an overdrawn account: "Their Lordships should, however, say that they find it difficult to understand how the judgment of the Board in Space Investments Ltd v Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd..., on which the claimants leaned heavily in argument, would enable them to overcome the difficulty that the money said to be impressed with the trust were paid into an overdrawn account and thereupon ceased to exist... The observations of the Board in Space Investments were concerned with a mixed, not a non-existent, fund."511

The swollen assets theory was rejected in Bishopsgate Investment Management Ltd. (in liquidation) v Homan512, which referred extensively with approval to the decision in Goldcorp.513 In Fungible Custody there is an existing distinguishable fund, in the form of the Client Holding. Accordingly, the tracing charge is imposed, not over the whole of the custodian’s assets, but over the Client Holding. No express language is required to create this charge, which arises by operation of law.

3. New Securities

However, the tracing rules cannot assist with New Securities, for here it is not a question of preserving existing property rights, but of allowing new ones to arise. The question then becomes, can equitable proprietary rights be conferred in an unallocated portion of a holding of property, where the parts of that holding are undivided and therefore incapable of allocation?

511 per Lord Mustill, at 827

512 [1994] 3 WLR 1270, per Leggatt L.J. at 1279: "I do not accept that it is possible to trace through an overdrawn bank account or to trace misappropriated money into an asset bought before the money was received by the purchaser." See also Re Haller & Co. [1894] 2QB 237 at 245 per Davey L.J.

513 This case included more frank criticism of Space Investments. See for example Dillon L.J at 1275, who refers to first instance decision of Vinelott J: "Vinelott J rejected the submissions of B.I.M. founded on the Space Investments case. He considered that Lord Templeman could not have intended to effect such a fundamental change to the well-understood limitations to equitable tracing."
4. Akin to Cash

Unlike an issue of Physical Bearer Securities, an issue of registered securities represents one undivided obligation (or undivided group of obligations) of the issuer. The registered securities making up such an issue represent undivided fractions of that obligation. For this reason registered securities are akin to cash within the banking system. The credit balance of a deposit account represents the debt of the bank to the account holder. Whatever the size of that balance, it represents one debt; a balance of £100 does not represent 100 separate debts for £1 each.

For this reason, the case law relating to the allocation of cash in bank accounts can be used to assess the Allocation Problem for registered securities.

(a) entire account

There is no doubt that a trust can be effectively created over the entire balance of an identified bank account.514

(b) no account

It is equally clear that where the intention is to create a trust over a sum of money, but the money in question is not placed in an identified account, the trust will fail for want of certainty of subject matter. In Mac-Jordan Construction Ltd v Brookmount Erostin Ltd (in receivership)515, Mac-Jordan, a building firm, agreed to undertake building works with

514 In Re Nanwa Gold Mines Ltd [1955] 3 All ER 219, Nanwa proposed a scheme for the reduction of its capital the issue of new shares. In a circular letter to shareholders it invited applications for new shares and explained that their issue was conditional on certain events, and that if these did not occur the application monies would be refunded, and that in the meantime they would be placed in a separate bank account. The application monies were so paid. A receiver was appointed under a debenture and the scheme was abandoned. On a summons to determine whether the application monies were the property of the company or of the applicants, it was held that it was the property of the applicants. Harman J noted that the promise to pay the money into a separate account accorded with section 51(3) of the Companies Act 1948 (now replaced by sections 86 and 87 of the Companies Act 1985 which were in turn repealed by Section 212(3) and Schedule 17 part 1 of the Financial Services Act 1986), which provided "All money received as aforesaid shall be kept in a separate banking account so long as the company may be liable to repay it under the last foregoing sub-section...". "That looks to me as though there had been an attempt to erect by statute a kind of trust for applicants in a case of this sort." (at 224.)

515 [1992] BCLC 350
Brookmount, a property developer, in a contract incorporating JCT standard terms, which included provision that Brookmount would pay retention monies into a separate fund and hold them as trustee for Mac-Jordan. No fund was ever set aside for the retention monies. Brookmount executed a floating charge over all its assets in favour of its bank, and later became insolvent. The bank appointed administrative receivers under its floating charge. Mac-Jordan claimed that it had a proprietary interest in the retention monies under a trust, and the that monies were therefore not subject to the charge.

Judgment was for the receivers. Because no fund had been set aside, there was no allocated subject matter for a trust, and accordingly the interest of Mac-Jordan in the retention monies was merely contractual: "In the event, however, no fund was ever appropriated and set aside by Brookmount in respect of the retentions made under the building contract. It is that default that has created the problems giving rise to this litigation."

516 If Brookmount had set aside a fund, Mac-Jordan would have been a beneficiary of the trust fund thereby constituted. 517

The case can be distinguished from Fungible Custody. The problem in Fungible Custody is that the assets to which a particular client's interest must attach is greater than that interest. The problem in this case was that there were no identified assets to which an interest could attach. If there had been such assets, there would have been an interest: "In the present case, the contractual right does not relate to any specific asset or assets. Indeed, if it did, there would be no problem. The plaintiff would on well-established principles, be able to claim an equitable interest in the asset or assets in question..." 518

516 per Scott LJ at 352.
518 at 357.
In other words, the case is not authority that a trust must fail for want of certainty of subject matter where it relates to part of a bulk, but rather than it must so fail where it relates to no assets at all.

c. *ex bulk*

The important question, therefore, is whether it is possible to create an equitable interest in cash *ex bulk*, i.e. over part of the balance of a bank account or other debt. There is authority that this is possible (although the nature of such an interest is variously described in the relevant cases as an assignment, a trust and a charge).

It has long been clear that a purported assignment of part of an debt is effective in conferring an equitable interest in the debt. In *Brice v Bannister* 519 an assignment of part of a future debt was recognised as a valid assignment of a chose in action (although the point that the assignment was only of part of the debt was not taken). In *In re Row, ex parte South*, 520 a direction by a creditor to a debtor to pay part of a debt to a third party was recognised a conferring a proprietary interest on the third party in the debt, although it is not clear whether that interest was by way of assignment or charge. (Again, in this case the point that the direction related only to part of the debt was not taken.) In *Durham Brothers v Robertson*, 521 there is some ambiguity as to the nature of the equitable interest conferred by a purported assignment of part of a debt. 522

In the 1920s the case law tends to identify the nature of the equitable interest as arising under an assignment and not merely a charge. *In re  

519 (1878) 3 QBD 569, C.A.
520 (1818) 36 ER 907
521 C.A. [1898] 1 Q.B. 765
522 See Chitty J. at 769: "...an engagement or direction to pay, out of a debt or fund, a sum of money constitutes an equitable assignment, though it does not operate as an assignment of the whole fund or debt. A mere charge on a fund or debt operates as a partial equitable assignment.".
Steel Wing Company. Lawrence J comments: "The assignment of part of a debt however operated in equity to transfer the part assigned, and consequently in my judgment constitutes the assignee a creditor in equity of the company in respect of that part." In the case of Palmer v Carey, Lord Wrenbury approves the dictum of Lord Truro in the earlier case of Rodick v Gandell (1852): "The law as to equitable assignment, as stated by Lord Truro in Rodick v Gandell [(1 D. M. & C. 763, 777, 778] is this: 'The extent of the principle to be deduced is that an agreement between a debtor and a creditor that the debt owing shall be paid out of a specific fund coming to the debtor ... will operate as an equitable assignment of the ... fund to which the order refers.'"

However, with modern case law it is less clear that equity can confer title (as opposed to a mere charge) over part of a debt. The case of Swiss Bank Corp v Lloyds Bank establishes the following principle:

This case concerned an English company, IFT, which borrowed money from SBC in order to buy securities in an Israeli company, FIBI. The Bank of England gave exchange control consent to the loan subject to conditions, one of which was that the loan should be repaid out of the FIBI securities or their proceeds of sale. In the loan agreement between SBC and IFT, IFT covenanted to observe all the Bank of England's conditions. IFT bought the securities with the borrowed money. Its ultimate parent, Triumph, went into financial difficulties. Lloyds agreed to assist Triumph on condition that IFT guaranteed Triumph's liabilities. To support this guarantee IFT equitably charged the FIBI securities to Lloyds. Triumph went into liquidation. IFT sold the securities and deposited the proceeds with Lloyds. SBC claimed a declaration that it was entitled to require repayment of the loan out of the proceeds.

Judgment was given at first instance for SBC. The covenant to observe the Bank of England's conditions was specifically enforceable. It gave SBC an equitable charge or interest in the proceeds, taking priority to Lloyds equitable charge. It was not necessary to show that the parties intended to create such a charge or interest, but merely that they had agreed (in effect) that the debt should be paid out of the specified property.
"...if a debtor undertakes to segregate a particular fund or asset and to pay the debt out of that fund or asset, the inference may be clear, in the absence of any contra indication, that the parties' intention is that the creditor should have such a proprietary interest in the segregated fund or asset as will enable him to realise out of it the amount owed to him by the debtor ... if the obligation be to pay out of the fund, a debt due by one party to the transaction to the other, the fund belonging to or being due to the debtor, this amounts to an equitable assignment pro tanto of the fund". 530 531

Thus it is clear that an equitable interest can be conferred over part of a pool of undivided property. Provided the pool is allocated, the part need not be. However it is not clear that this interest is a trust interest; it may be merely a charge. 532

5. Equitable Charge

It has been established that equitable charges can be granted over an unallocated portion of a holding of property, where the parts of that holding are undivided. This charge arises from an agreement to satisfy a contractual obligation out of an earmarked fund or pool. This principle may be applied to the Allocation Problem as follows.

The decision was reversed on appeal, on a point of fact. It was held that the parties had not agreed to the repayment of the debt out of specified property, but rather merely to observe the Banks conditions from time to time (which conditions might have changed so as not to require repayment in that manner). An appeal by SBC to the House of Lords was dismissed. 530

Although SBC lost on a point of fact, the principle forming the basis of the first instance decision was upheld. 530

per Buckley L J at 426, who cites the cases of Palmer v Carey and Rodick v Gandell as authority for this statement. 531

At first instance, a slightly different basis for the equitable interest is given, as follows: "the doctrine that, in the eyes of equity, that which ought to have been done is to be treated as having been done ... Once the position is reached that an order for specific performance could have been made against the legal owner if the matter had been brought before the court, thereafter the legal owner holds the property shorn of those rights in the property which the court of equity would decree belongs to the other" (per Browne-Wilkinson J at 866). 531

Browne-Wilkinson J refers to Barclays Bank v Quisclose Investments Ltd [1968] 3 All ER 615 and comments, "In my judgment that case is wholly consistent with the principle that a contractual promise to apply earmarked monies for a specific purpose creates an equitable interest in those monies, whether by way of charge or by way of trust." (at 868 at first instance). See also Re ILG Travel Ltd [1995] 2 BCLC 128. 532
Under the custody agreement providing for Fungible Custody, the custodian agrees to deliver to the client (or to its order) out of the Client Holding securities equivalent to those originally deposited. Thus there is an agreement to satisfy a contractual redelivery obligation out of an earmarked pool (the Client Holding).

There is no express agreement to create a charge. However, this does not prevent it from arising: "In my judgment if a contract binds one party to pay a debt out of specific property, such a contract is specifically enforceable and creates an equitable charge or interest in the specific property, whether or not the parties knew and intended the legal consequence to follow. To put it another way, parties must be taken to intend the legal consequences of the contracts they make."

Indeed, the absence of express agreement to create a charge has the benefit of obviating the need for registration.

The general nature of a charge is the subject of some debate. Professor Goode argues that a charge "... is a mere encumbrance and does not operate to transfer any proprietary interest". However, in the context of tracing, it operates to confer a proprietary interest. Thus when Buckley L.J. considers the nature of the equitable charge in the Court of Appeal in *Swiss Bank Corporation v Lloyds Bank Ltd* he states that an equitable charge may "... take the form either of an equitable mortgage or of an equitable charge not by way of mortgage ... The essence of any transaction by way of mortgage is that a debtor confers on his creditor a proprietary interest in the property of the debtor, or undertakes in a binding manner to do so...".

Thus, the interest of the custody client under such an implied charge is not registrable, and is proprietary. However, it is still unclear that such an interest

533 *Swiss Bank v Lloyds Bank* Per Wilkinson Browne J at first instance, at 869.

534 The registration requirements of the Companies Act 1985 relate to "... a charge created by a company..." (CA 1985 Section 395(1)). The point is brought out in the proposed new version of section 395(2) (to be substituted by sections 92 et seq of the Companies Act 1989: "Charge" means any form of security (fixed or floating) over property, other than an interest arising by operation on law;"


536 [1980] 2 All ER 419 at 425, 426.
is as satisfactory as equitable title. Because no one client controls the dealings in the whole of the Client Holding (merely that undivided fraction of it attributable to its account) this implied charge would probably be classified as a floating charge. A number of disadvantages are associated with floating (as opposed to fixed) charges. Although in this case the charge is not registrable, it would be postponed to the claims of preferential creditors in the liquidation of the custodian.

Another problem with a tracing charge is the "lowest intermediate balance" rule discussed in Re Goldcorp. In this judgment Lord Mustill endorsed the decision in Roscoe v Winder that the ability to trace into an account is limited to the lowest balance of that account between the time when the trust assets entered the account, and the time when tracing is sought. Whether or not this rule would be applied to the Client Holding is uncertain, for "The law relating to the creation and tracing of equitable proprietary interests is still in a state of development." However, if applicable, it would clearly be problematic in an actively traded Client Holding that might fluctuate in size from time to time.

It is therefore necessary to ensure that the interest of the client arises under a trust and not merely a change.

6. Trust Interest

Hunter v Moss may be of assistance in the search for authority that a trust can be created over an unallocated part of a holding of registered securities. The facts of this case were as follows. Moss was the registered holder of 950

537 A test of a floating charge is that the chargor retains freedom to deal with the charged assets: Siebe Gorman v Barclays [1979] 2 Lloyds Rep 142

538 (and become generally unenforceable upon administration)

539 [1915] 1 Ch 62

540 "In these circumstances the bullion belonging to the Walker & Hall claimants which became held by the company's receivers consisted of bullion equal to the lowest balance of the metal held by the company at any time: see James Roscoe (Bolton) Ltd v Winder [1915] 1 Ch 62." (at 831.)

541 Goldcorp, per Lord Mustill at 832.

shares in a company with 1,000 shares in issue. Moss made a declaration of trust over 5% of the company's issued share capital in favour of Hunter. A valid trust was held to have been created over 50 of Moss's shares. Moss applied by motion for the judgment to be recalled, arguing that the trust failed for want of certainty of subject matter.

The motion was dismissed by Rimer Q.C., on the basis that, in a trust over intangibles, the requirement for certainty of subject matter does not necessarily entail segregation or appropriation. "The defendant did not identify any particular 50 shares for the plaintiff because to do so was unnecessary and irrelevant. All 950 of his shares carried identical rights ... Any suggested uncertainty as to subject matter appears to me to be theoretical and conceptual rather than real and practical."

This decision should be treated with some caution. On the particular facts of the case, it was clearly in the interests of justice that a valid trust should be found. The judgment, which was pragmatic, focused more on the merits of the dispute before the court than the wider principles of equity discussed earlier in this chapter. Furthermore, the shares in question were in a private company, and the implications for the custody and settlement in the markets in publicly traded securities were not considered.

It would be prudent to follow the greater weight of the combined authority of the other cases cited in this section, that in the absence of allocation, an equitable interest cannot subsist as an interest under a trust, but can only take effect as a charge.

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543 per Colin Rimer QC (sitting as deputy High Court Judge) at 946.

544 See David Hayton, Uncertainty of Subject-Matter of Trusts, (1994) 110 LQR 335. In particular, inter vivos transfers are not distinguished from testamentary transfers.

545 "Dillon L.J. then dealt with Mac-Jordan Construction Ltd v Brookmount Erostin Ltd (1991) 56 B.L.R 1 but did not get to the heart of it." David Hayton, Uncertainty of Subject-Matter of Trusts, p. 337.
7. Conclusions - Registered Securities

A trust requires allocated subject matter, and cannot be created ex-bulk. A charge is different, for it can (and often does) attach to an asset without exhausting it. A charge is therefore the natural (and probably only possible) characterisation of an ex-bulk equitable interest. However a charge is less satisfactory for the custody client than an interest under a trust.

The natural solution to this problem is the same as the solution to the Allocation Problem for Physical Registered Securities: expressly to create a trust over the whole of the client holding, for the clients together as tenants in common.

E. Conclusions

Where the securities of more than one client are commingled in Fungible Custody, there is some doubt that such clients have adequate proprietary rights in such securities. Such doubt could readily be removed by legislation. An alternative approach is contractual establishing co-ownership rights in equity. Such wording should be included in the custody agreement as a matter of prudence.

546 See, for example, the Belgian Royal Decree No 62 of November 1967, the Luxembourg Grand-Ducal Decree of February 1971, the German Depotgesetz of 1937 and article 8-302 of the New York Uniform Commercial Code.

547 See, for example, CGO Reference Manual section 8.2.8 and Talisman Clearing House Regulations, Regulation E.5.1.3.a.
"It has not been easy for the conflict of laws to adapt itself to the changes in social and commercial life which the twentieth century has witnessed."

A. General

1. Legal Uncertainty

Two great changes have affected the securities markets in the late 20th century: internationalisation and computerisation. The rise of cross border investment made global custody necessary; computers made it possible. But although securities business is international and electronic, settled law does not yet reflect this. Chapters 3 and 4 considered how traditional concepts of personal property fail adequately to account for assets in the securities markets which are intangible and unallocated.

The legal aspects of cross-border arrangements are inherently unpredictable.

While much admirable work has recently been done in advocating and implementing reform of private international law on a local and multi-lateral basis in developed jurisdictions, such reform will not introduce certainty into the securities markets as long as courts of unreformed countries may assume jurisdiction. The problem is particularly acute in the emerging markets, where local courts may be unlikely to decline jurisdiction in matters concerning locally issued securities, and where the legal understanding of cross-border securities arrangements may differ from that in the developed markets. For this reason,

548 This is a complex area of law, and discussed in highly summary form in this section. The following is not a systematic treatment of the subject, and merely considers those aspects of conflicts of law that are of particular interest in the context of the proprietary aspects of global custody.


551 See the revised Article 8 of the US Uniform Commercial Code, section 8-110.

- 150 -
in practice, the forum of a dispute is the key issue.\textsuperscript{552} Further, enforcement of judgments is of central importance. Even where judgment is obtained in England concerning assets held abroad, local recognition and enforcement of that judgment remains a further obstacle to be surmounted, while the enforcement of competing local or foreign judgments against the assets cannot be excluded.

This chapter will consider English private international law as it relates to global custody, and the following chapter will consider general issues of private international law as they relate to taking security over, and the intermediation of, custody assets.

2. Cash and Securities

Cases concerning the securities held in global custody may involve private international law, as such securities may constitute property situated in a foreign country. It might be thought that the same will be true of the cash element of a custody portfolio, but this is not the case.

A portfolio of international securities is likely to generate multi-currency cash balances. This is because income and proceeds of sale of securities are likely to be denominated in the currencies that are legal tender in the jurisdictions from which they are paid. Because of the structure of the international banking settlement system, currency is generally held in the jurisdiction in which it is legal tender.\textsuperscript{553} Thus, where a London global custodian\textsuperscript{554} maintains a credit balance of US $1 million for a custody client, it will not of course keep a huge pile of dollar bills in its vaults in London to match that credit balance. The asset of the global custodian corresponding to that credit balance will be a further credit balance of $1 million (or, more likely, part of a larger balance) in favour of the global custodian in the books of its correspondent bank in New

\textsuperscript{552} Once an action concerning foreign securities has been commenced in the jurisdiction of the issuer, the English courts would be most unlikely to entertain an action on the same issue. This underlines the importance of jurisdiction clauses in global custody documentation.

\textsuperscript{553} See the discussion of eurodollars by Terence Prime, in \textit{International Bonds and Certificates of Deposit}, Butterworths, London, 1990, pp 4,5

\textsuperscript{554} It is assumed here that the global custodian in London is a bank.

- 151 -
The dollar account of the global custodian at the New York correspondent may be said to constitute dollars, while that of the custody client at the London global custodian may be said to constitute eurodollars. Where U.S. dollar income or proceeds of sale of custody securities are paid to the global custodian on behalf of custody clients, they are likely to be paid directly to its New York correspondent bank.

Because of the use of correspondent banks, it might be thought that the global custodian is holding the client's non-sterling money overseas. However, this is not the case. The asset of the client is not the dollars in New York, but the eurodollars in London. Chapter 4 considered the legal relationship between the custodian and its client. It was seen that, in the case of that part of the custody portfolio consisting of cash, this relationship is generally that of debtor and creditor. In other words, where a custody portfolio includes a positive balance of $1 million, the asset of the custody client is a debt owed to it by the global custodian to pay the client $1 million. The eurodollar deposit of the global custodian with the New York correspondent is the asset, not of custody clients, but of the global custodian. The cash asset of the custody client is not located in a foreign country. For this reason, the discussion of private international law in this and the following chapter will be confined to securities.

3. Approach of the courts

"The questions that arise in conflict of laws cases are of two main types: first, has the English court jurisdiction to determine this case? And secondly, if so, what law should it apply?" As the first issue before the courts will always be the question of jurisdiction, it will be considered this first in section B below. Section C will consider the approach of the courts to choice of law in general terms.

B. Jurisdiction

The correspondent bank is also most unlikely to keep a pile of dollar bills; instead, its asset corresponding its dollar liability to the global custodian, is likely to be a credit balance in its favour with the Federal Reserve Bank, or a settlement bank if it does not have an account at the Fed.

Dicey and Morris, volume I. p. 4. The passage continues, "There may be sometimes a third question, namely, will the English court recognise or enforce a foreign judgment purporting to determine the issue between the parties" Recognition of foreign judgments will not be considered in detail in this work.
The rules that determine whether the English courts will have jurisdiction in any particular case concerning global custody, differ according to whether or not the matter is related to insolvency. Insolvency jurisdiction is considered in chapter 7. Non-insolvency jurisdiction is considered in this section.

Every action in the English High Court must be started by writ. Two different regimes apply depending on whether or not the defendant is domiciled in the EC (including England) or the EFTA. If it is so domiciled, the Civil Jurisdiction and Judgments Act 1982 (as amended by the Civil Jurisdiction and Judgments Act 1991) ("the Act") applies, harmonising English jurisdiction rules with European rules. Broadly speaking, if the defendant is domiciled elsewhere, the general law jurisdiction rules apply. These two regimes will be considered in sections 1 and 2 below; section 3 will go on briefly to consider the circumstances in which the court may lose or decline to exercise jurisdiction which it prima facie has.

1. The Act

The Act gives effect in English law to the Brussels and Lugano Conventions on Jurisdiction and the Enforcement of Judgments ("the Conventions"\textsuperscript{557,558}. The Brussels Convention was made between EC member states, and the Lugano Convention was made between EC and EFTA member states. The two Conventions are in like form. Title II of each of the Conventions relates to jurisdiction. Austria, Belgium, Denmark, Germany, Greece, Finland, France, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Sweden, Switzerland and the United Kingdom have signed one or both of the Conventions, and they will be referred to as Contracting States.

a. scope

Broadly speaking, the Conventions cover civil and commercial matters (but not insolvency-related matters or arbitration).

\textsuperscript{557} For the full titles of the Conventions, see article I(1) of the Act.

\textsuperscript{558} In sections 2(1) and 3A(1) of the Act respectively.
b. *domicile*

The rules determining jurisdiction under the Conventions are primarily based on the domicile of the defendant. The general rule is that a defendant may be sued in the Contracting State where he is domiciled, and may be sued by another Contracting State only in accordance with special rules of jurisdiction.

To determine the meaning of domicile, the Conventions and the Act must be read together. Under the Conventions, the seat of a company or other legal person is treated as its domicile\(^{559}\). In order to determine that seat, the courts must apply its rules of private international law\(^{560}\). These rules are provided in section 42 of the Act.

Under section 42, companies having a seat in England would generally include both companies incorporated in England, and foreign companies having a registered branch in England, having (in each case) a place of business (i.e. carrying on any activity\(^{561}\)) in England (whether or not amounting to central management and control). Thus, foreign sub-custodians may be domiciled in England if they have a London branch. A company has its seat in a Contracting State other than the United Kingdom if (broadly) that state is *either* its place of incorporation and registered office (or official place of service) *or* its place of central management and control\(^{562}\) and it has its seat in that state under local law\(^{563}\).

c. *non-exclusive jurisdiction*

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559 This provision is duplicated in section 42(1) of the Act.

560 Article 53, first paragraph.

561 "business" includes any activity carried on by a corporation or association, and "place of business" shall be construed accordingly" (section 42(8)).

562 Section 42(6)

563 Section 42(7).
defendant domiciled in England. If the defendant is domiciled in England, the English courts generally have jurisdiction.\(^{564}\) They will not, however, have jurisdiction if another Contracting State has exclusive jurisdiction (see section [d] below) or if proceedings have already begun in another Contracting State.

This might confer jurisdiction on the English court where a suit is brought against an English global custodian or sub-custodian, or a foreign sub-custodian with a branch in London.

- English trust. The English courts generally have jurisdiction in claims against a trustee or a beneficiary under a trust if the trust is domiciled in England\(^{565}\) or in connection with a trust governed by English law\(^{566}\).

It was seen (in chapter 4) that the relationship between the custodian and its client under English law is likely to be characterised as that of trustee and beneficiary. A trust is domiciled in England for this purpose\(^{567}\) if English law is the system of law with which the trust has its closest and most real connection. This should be the case if a global custody agreement is in place the global custody relationship (and therefore the trust) is governed by that document. Therefore, assuming the global custody agreement is governed by English law, the English court should have jurisdiction in all litigation against the global custodian or its client concerning the proprietary and fiduciary aspects of the relationship between them.

- movable property in England. While the situs of property is important in cases outside the scope of the Act and the Conventions, in general, under the Act and the Conventions, jurisdiction follows the domicile of the defendant, and not the situs of property. However, an exception is

\(^{564}\) Article 2.

\(^{565}\) Article 5(6) of the Conventions

\(^{566}\) Article 17 paragraph 2 of the Conventions.

\(^{567}\) In accordance with article 53 of the Conventions and section 45 of the Act. "Of course it is artificial and novel to speak of the domicile of a trust at all. But it is a convenient form of shorthand." Dicey & Morris, The Conflict of Laws, p. 81.
made under the Act where the defendant is domiciled in Scotland or Northern Ireland and the case concerns proprietary rights in movable property.\footnote{568}

\textbf{d. exclusive jurisdiction}

\textit{- public register.} Regardless of domicile, the Conventions confer exclusive jurisdiction on the courts of the relevant Contracting States in certain circumstances. These include proceedings which have as their object the validity of entries in public registers\footnote{569}, and in this case jurisdiction is conferred on the courts of the Contracting State in which the register is kept\footnote{570}. Dicey comments, "In England it is not likely to be of practical significance except in connection with problems relating to registered land..."\footnote{571}. However, it might be argued that public registers for this purpose include the registers of public companies. Thus, if a custody client sought an order that a French register be amended in its favour, the French courts might have exclusive jurisdiction in the matter.

\textit{- submission.} Very broadly, where two parties, one of whom is domiciled in a Contracting State\footnote{572}, agree (in customary written form) that the court of a Contracting State are to have jurisdiction in connection with their relationship, that court will have exclusive jurisdiction.\footnote{573}

\footnote{568}{Including security interests, and the right to dispose of the property. Schedule 4, article 5(8)}

\footnote{569}{Other cases are (broadly) proceedings concerning immovable property, the constitution of companies, patents and trademarks and the enforcement of judgments.}

\footnote{570}{Article 16(3) of the Conventions.}

\footnote{571}{Volume 1, p 385.}

\footnote{572}{A different rule applies for such agreements where neither party is so domiciled: article 17 paragraph 2.}

\footnote{573}{Article 17 of each of the Conventions, which are in different form. For the position before the Conventions were implemented, see Trendtex Trading v Credit Suisse [1980] I Q.B. 629, per Denning MR. at 658: "At once we come upon the clause which gives exclusive jurisdiction to the Court of Geneva. That clause must be given full effect unless its enforcement would be unreasonable and unjust or that the clause was invoked for such reasons as fraud."}
Submission to the jurisdiction of a Contracting State in a trust instrument confers exclusive jurisdiction in any proceedings brought against (inter alia) trustee or beneficiary involving the trust relationship. On the basis that the global custodian is a trustee, this would include jurisdiction clauses in the global custody agreement.

e. Summary

As a broad rule, in non-insolvency related proprietary matters, it should be possible to sue the following persons in England:

- the London global custodian (probably under every head discussed above other than public register and movable property);
- the client (if it is incorporated in England or has an English branch, and carries on some activity in England - English domicile
- or if the client is domiciled in another Contracting State and the global custody agreement is governed by English law - English trust- , or again if there is a submission to the English courts in the global custody agreement); and
- the foreign sub-custodian which is domiciled in another Contracting State (if the sub-custody agreement is governed by English law - English trust- or contains a submission to the English court.

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574 (For exceptions to this rule, see Article 17 paragraph 4.)

575 It should also be noted that under article 24 of the Conventions, the English courts have jurisdiction “for such provisional, including protective, measures as may be available under the law of [England], even if, under this Convention, the courts of another Contracting State have jurisdiction as to the substance of the matter.” Thus, even where the substance of a dispute is to be brought in France, the English courts would be able to grant a mareva injunction (restraining a defendant from removing his assets out of the jurisdiction pending trial) or an Anton Piller order (for the inspection of premises to discover documents or chattels to which the plaintiff may be entitled). Both of these may affect an English custodian holding documents or securities for its clients in London.
2. General Law

In cases outside the Act (broadly, where the defendant is not domiciled in the EC or EFTA)\(^{576}\) the jurisdiction rules under the general law will apply, as follows. Whereas the "European" regime discussed above is based on *domicile*, the "old English" regime discussed below is based on *presence*.

The English court has jurisdiction if the defendant is present (at the time of service of the writ, even fleetingly) in England, or submits to the jurisdiction of the court. Otherwise, the court has discretionary power to assume jurisdiction (by giving leave for service out of the jurisdiction) in the cases mentioned in Order 11 of the Rules of the Supreme Court.

a. *present in England*

Service of a writ is permissible on a defendant who is present in England, provided it is not domiciled in another Contracting State and provided also the matter is not one in which another Contracting State has exclusive jurisdiction.\(^ {577}\) In addition to companies incorporated in England and those having registered branches in England, any foreign company carrying on business in England (whether or not registered here) is present for these purposes.\(^ {578}\)

Thus, it should be possible to sue a foreign sub-custodian which carries on business in London (whether or not through a registered branch) provided (broadly) that its head office is not located in the EC or EFTA. This is true whether or not the sub-custody agreement is governed by English law or contains a submission to the jurisdiction of the English court.

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576 and in cases otherwise outside the scope of the Conventions, but not in cases in which article 16 of the Conventions confers exclusive jurisdiction on a Contracting State, regardless of domicile (e.g. proceedings concerning public registers, and also not in cases where the parties have submitted to the jurisdiction of a Contracting State in accordance with article 17).

577 Dicey, rule 24, volume 1, p 298.

578 Service may be effected under the Companies Act 1985 section 725(1) (in the case of English incorporated companies) and section 695(1) in the case of English registered branches of foreign companies, and otherwise under Order 65 rule 3 of the Rules of the Supreme Court (in the case of companies carrying on business in England at common law but unregistered at the companies registry).
court (although an exclusive submission to another court might displace
English jurisdiction; see section 3 below).

b. submission

The court has jurisdiction where the defendant submits to it. Submission
can be inferred from conduct\textsuperscript{579} or from contractual terms. Such a
jurisdiction clause will be effective, provided there is proper provision for
the service of process on the defendant (or its agent).\textsuperscript{580}

Thus a well drafted English jurisdiction clause (appointing an English
process agent) will bring a foreign sub-custodian within the jurisdiction
of the English court. It would seem that this is the case even where the
action relates to movable property which is situated in another
jurisdiction.\textsuperscript{581} Therefore, in the absence of insolvency, the English
court could make an order concerning the ownership of foreign securities.
The willingness of foreign courts to recognise such an order may be
another matter.

c. leave to serve writ outside the jurisdiction

In addition, the English court has a discretionary power to assume
jurisdiction by granting leave to serve a writ outside the jurisdiction in
certain circumstances under RSC Order 11, r1(1).\textsuperscript{582} The plaintiff must

\textsuperscript{579} e.g. acknowledging service of the writ.

\textsuperscript{580} Where (broadly) a process agent is appointed in England, service may be effected without leave of the court
for service abroad: RSC Order 10, rule 3.

\textsuperscript{581} Although the courts of another Contracting State will have exclusive jurisdiction in matters relating to
immovable property (i.e., broadly, property associated with land) under Article 16 of the Conventions, there
is no equivalent provision for movable property.

\textsuperscript{582} Provided, of course, the defendant is not domiciled in a Contracting State, or the matter is one over which a
Contracting State has exclusive jurisdiction.

- 159 -
make out a strong case before leave will be granted.\textsuperscript{583} The grounds listed in O.11, r.1(1) include the following\textsuperscript{584}.

\textit{English contract.} Service of a writ out of the jurisdiction is permissible with the leave of the court if the claim is brought to enforce, rescind, dissolve, annul or otherwise affect a contract which (inter alia) was made within the jurisdiction.\textsuperscript{585}

Accordingly, an action against a foreign sub-custodian which has no presence in England, under a sub-custody contract which is not governed by English law and which does not contain a submission to English jurisdiction, may be within this provision if it was accepted by fax received in England.

\textit{Property situated in England.} Service of a writ out of the jurisdiction is permissible with the leave of the court if (inter alia) the claim is made to assert, declare or determine proprietary or possessory rights, or rights of security, in or over movable property, or to obtain authority to dispose of movable property, situate within the jurisdiction.\textsuperscript{586} “This jurisdiction, it will be observed, is essentially directed \textit{in rem}, and does

\textsuperscript{583} Under O.11, r.4(2), no leave will be granted “unless it shall be made sufficiently to appear to the Court that the case is a proper one for service out of the jurisdiction under this Order.”

\textsuperscript{584} Service of a writ out of the jurisdiction is also permissible with the leave of the court if relief is sought against a person domiciled within the jurisdiction (O.11 r.1(1)(a)). (Domicile for this purpose is determined in accordance with the Act: O.11, r.1(4)). However, this is unlikely to be important for present purposes, as any company domiciled in England is likely also to be present in England.

\textsuperscript{585} “If the parties enter into negotiations by correspondence from different countries, the contract is made where the letter of acceptance is posted. The same is the case if the acceptance is by telegram. But in commercial transactions today communication by telephone, telex and telefax is much more common than by post or telegram. It is now well established, following the decision of the Court of Appeal in \textit{Entores v Miles Far East Corporation} (which has been approved by the House of Lords) that is the parties use “instantaneous” means of communication such as telephone, telex or telefax, the contract is made where the acceptance is communicated to the offeror.” \textit{Dicey}, volume 1, p. 329.

\textsuperscript{586} O.11, r1(1)(a).
not extend to personal jurisdiction over persons outside England beyond dealing with property in England.\textsuperscript{587}

Chapter 4 argued that the proprietary interest of the client in the custody assets will in most cases be an interest under a trust of which the global custodian is the trustee. The location of this interest will be considered in section [E] of chapter 7 below, where it will be argued that such trust interest is situated in the jurisdiction of the custodian, i.e. in England. This has the possible result that, irrespective of the location of the underlying securities, the English courts have jurisdiction to hear cases concerning all aspects of the client's proprietary rights in the custody assets, and the claims of others to whom the client has given a security interest (or other proprietary interest) in the portfolio (e.g. the global custodian under "flawed asset" or security arrangements, third party secured lenders or tracing claimants). The interposition of the custody trust, it is argued, confers jurisdiction on the English courts in such matters. This is particularly important in connection with the use of the portfolio as collateral.

- \textit{English law trust}. Service of a writ out of the jurisdiction is permissible with the leave of the court (broadly) in an action against a trustee to execute a written trust governed by English law\textsuperscript{588}. This applies whether or not the trust property is situate in England\textsuperscript{589}. On the basis that the global custodian is a trustee, this may apply to actions to enforce the terms of the global custody agreement.

3. \textbf{Loss of Jurisdiction}

The English court may lose or decline jurisdiction which it \textit{prima facie} has in accordance with certain rules, including the following.

\textsuperscript{587} This provision is modelled on article 5(8) of Schedule 4 to the Act, which confers jurisdiction under the Act where movable property is situated in England and the defendant is domiciled in Scotland or Northern Ireland

\textsuperscript{588} RSC. Ord 11. r1(1)(j).

\textsuperscript{589} See \textit{Dicey}, vol 1. p. 354.
The rule of sovereign immunity590 provides that a foreign state is generally immune from the jurisdiction of the English courts, subject to important exceptions591.

In accordance with the doctrine of forum non conveniens the English courts may inter alia stay or strike out an action when this is necessary to prevent injustice. The doctrine is based on the view than some other forum is more appropriate, and may be invoked to prevent jurisdiction shopping592. However this discretion does not seem to extend to cases in which jurisdiction is conferred by the Convention593.

The related doctrine of lis alibi pendens applies when simultaneous actions are pending in different Contracting States involving the same parties and the same or related matters. In the case of simultaneous actions in England and (broadly) EC or EFTA countries, the Conventions require proceedings in the second jurisdiction to be stayed, and jurisdiction to be declined, in certain circumstances594.

Where the parties to a contract have agreed to submit the contract, to the exclusive jurisdiction of a foreign court, the English court will stay proceedings brought in England unless the plaintiff proves that it is just and proper to allow the proceedings to be brought.595 Where exclusive submission is to the court of a Contracting State, the English court has no jurisdiction596.


591 There is an exception in relation to commercial transactions: section 3(1) of the Act, according with the earlier common law rule reflected in Trendtex v Central Bank of Nigeria [1977] Q.B. 529 (C.A.).


593 See Dicey, volume 1, p. 274.

594 See section 8 of the Conventions.

595 See Dicey, volume 1, pp. 31 et seq.

596 Unless neither party is domiciled in a Contracting State, in which case the English court has jurisdiction only if the chosen court has declined jurisdiction: article 17 of the Conventions. This restriction applies where submission is in customary written form. This is the corollary of the exclusive jurisdiction provisions of article 17.
The English court also has no jurisdiction in matters such as those concerning the validity of entries in public registers maintained in a Contracting State other than the UK, where the Conventions confer exclusive jurisdiction on the court of that other Contracting State.

It is impossible to address the entire range of litigation that might in theory be brought in the English courts in connection with global custody. Rather than attempt to do so, this chapter will consider the general principles of choice of law before turning to the English private international law aspects of those issues that were considered under English domestic law in chapter 3, and which concern the impact of computerisation on the nature of securities. These are, integrity of transfer, formalities of transfer and negotiability.

C. Choice of Law; General Principles \(^{597}\)

1. The Issue

Once it has been established that the English court has jurisdiction in a matter, it is necessary to determine whether it should apply English domestic law or foreign law.

2. Approach

   a. categories and connecting factors

   English private international law's approach is (firstly) to place cross-border scenarios into categories, and (secondly) to identify factors in those scenarios that connect them to particular jurisdictions. \(^{598}\) Categorisation is determined by English law as the law of the forum or *lex fori*. \(^{599}\) Thus, in a matter before the English courts concerning

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598 See Dicey, vol 1, p 30.

599 "There can be little doubt that classification of the cause of action is in practice effected on the basis of the law of the forum. Equally, connecting factors are always determined by English law as *lex fori*." North and Fawcett, Cheshire and North's Private International Law, 12ed, Butterworths, London 1992, p 45. See also Moshinsky, The Assignment of Debts in Conflict of Laws, [1992] LQR 109, 591 at 621: "... it is legitimate for the English
foreign securities. English domestic law would determine the legal location or *situs* of the securities.

b. **terms**

The terms for the connecting factors are customarily given in Latin. 600

2. **Approach to Foreign Law**

Foreign law must be proved as fact. 601 If foreign law is not pleaded and proved, English law will be applied. 602

3. **Renvoi**

courts to apply principles of English law to define the nature of the dispute...". However, "...the judge must not rigidly con"ine himself to the concepts or categories of English internal law, for if he were to adopt this parochial attitude, he might be compelled to disregard some foreign concept merely because it was unknown to his own law. The concepts of private international law, such as "contract", "tort", "corporation", "bill of exchange", must be given a wide meaning in order to embrace "analogous legal relations of foreign type" [Nussbaum]." (Cheshire, pp 45, 46). For an example of this approach being taken by the Swiss Federal Court in relation to a trust, see Harrison v Credit Suisse, discussed in chapter 7 section E below. See the first instance decision of Macmillan Inc v Bishopsgate Investment Trust PLC (No 3) [1995] All ER 747, per Millett J at 760: "the *situs* of a thing, like any other connecting factor, must be ascertained by reference to the *lex fori*."

600 "The *lex causae* is a convenient shorthand expression denoting the law (usually but not necessarily foreign) which governs the question. It is used in contradistinction to the *lex fori*, which always means the domestic law of the forum, _i.e._ (if the forum is English) English law. The *lex causae* may be more specifically denoted by a variety of expressions, usually in Latin, such as ... *lex loci contractus* (law of the country where a contract is made), *lex loci solutionis* (law of the country where a contract is to be performed or where a debt is to be paid), ... *lex situs* (law of the country where a thing is situated), ... *lex loci actus* (law of the country where a legal act takes place), *lex materiae* (law of the country in whose currency a debt or other legal obligation is expressed)." Dicey, vol 1, p. 30.

601 "In any case to which foreign law applies, that law must be pleaded and proved as a fact to the satisfaction of the judge by expert evidence or sometimes by certain other means." Dicey, rule 18(1). See also Baker v Archer-Shree (H.L.) [1927] A.C. 844, per Lord Blanesburgh at 874: "The true effect of American, as of any other foreign law, is in England a question not of law but of fact." The consequences of treating foreign law as a question of fact are that it must be pleaded and proved (usually by expert evidence: see section 4(1) of the Civil Evidence Act 1972).

602 See Dicey Rule 18(2). See also Baker v Archer-Shree [1927] A.C. 849, per Viscount Sumner at 849: "There is no finding as to the law of the State of New York and, in accordance with the settled rule, we must presume that the general law of New York which is here relevant - namely, the law of trusts and wills - is the same as our own."
"The problem of renvoi arises whenever a rule of the conflict of laws refers to the "law" of a foreign country, but the conflict rules of the foreign country would have referred the question to the "law" of the first country or to the "law" of some third country." 603 When English law refers a matter to, say, the law of France, does that mean the domestic law of France, or French private international law, which may well refer the matter on somewhere else (or back to England again, creating a hall of mirrors)?

Although renvoi has long enchanted commentators, "The history of the renvoi doctrine in English law is the history of a chapter of accidents." 604 It originated in 19th century cases concerning the formal validity of wills. It is excluded by the Rome Convention on the Law Applicable to Contractual Obligations 605. In the light of recent judicial comments, renvoi should be treated as inapplicable in commercial matters. 606

D. Integrity of Transfer

Chapter 3 considered the impact of computerisation on the legal nature of securities, and argued that, under English domestic law, it had significant implications for the integrity and ease of transfers of bearer securities, as it involved the loss of negotiable status. That chapter also indicated that some of the problems caused by computerisation under domestic law may be cured under private international law. This section returns to these

603 Dicey, volume 1, p. 71.
604 Dicey, volume 1, p. 77.
605 Article 15
606 See the first instance of Macmillan Inc v Bishopsgate Investment Trust plc (No 3) [1995] 3 All ER 747, per Millett J at 766. "There is no authority on the question, [of whether English law applies the doctrine of renvoi in this context] but in my judgment the question should be answered in the negative. The doctrine has most frequently been applied in the field of succession. Outside that field it seems that it has been applied only to legitimation by subsequent marriage. It has not been applied in contract or other commercial situation. It has often been criticised, and it is probably right to describe it as largely discredited. It owes its origin to a laudable endeavour to ensure that like cases should be decided alike wherever they are decided, but it should now be recognised that this cannot be achieved by judicial mental gymnastics but only by international conventions.

See also 777: "In my judgment there is or ought to be no scope for the doctrine of renvoi in determining a question of priority between competing claims to shares..."
questions, starting with the approach of the English courts to conflict of laws issues relating to the integrity of transfers of securities held in global custody. The following sections will consider conflicts of law in relation to ease of transfer and negotiability.

As section B above indicated, the first step is to establish jurisdiction.

1. Jurisdiction

According to the jurisdiction rules discussed in section B the English courts would have jurisdiction, for example, to hear an action against a London-based global custodian and/or its London-based client, by a third party victim of fraud who claims an interest in custody securities that were brought from or through a fraudster. In this example, no bad faith on the part of the custodian or the client is alleged. The securities in question are French bonds held through Cedel, and the fraudster, who is based in London, has transferred the securities to the custodian under an English law transfer, with settlement through Cedel into the account of the sub-custodian ("the Example").

The English courts would have jurisdiction to hear the matter (on the basis of the domicile or presence in England of the defendant(s)) and London would be a likely forum for the claim.

2. Categorisation

It was seen (in section [C]) that, after jurisdiction has been established, the next step in conflicts of laws is to categorise the matter. The leading case on the issues raised in the Example is Macmillan Inc. v Bishopsgate Investment Trust PLC (No 3)607.

Macmillan, a company in the Maxwell group and a Delaware corporation, brought an action to recover shares in a New York subsidiary, Berlitz ("the Shares"). The Shares had been held by BIT as nominee for Macmillan and (without Macmillan’s authority) were put up by BIT as security to various financial institutions (the defendants in the action) to secure borrowings by the Maxwell group. By the time of the hearing all the Shares had been transferred

607 [1995] 3 All ER 747 (first instance);
to those financial institutions in order to perfect their security interests. By agreement between the litigants all the Shares had been sold. "The question for determination now is whether Macmillan retained an interest in the shares superior to that of any of the Defendants and is accordingly entitled to the corresponding part of the proceeds of sale. "608 "Each of the Defendants claims to have been, or ... to have derived title through, a bona fide purchaser for value of the shares without notice of Macmillan's interest."609 At first instance, judgment was given for the defendants, on the basis that they were bona fide purchasers for value without notice. This judgment was upheld in the Court of Appeal.610

The initial question of characterisation was disputed.611 However, the approach of the court was clear. "In my judgment the Defendants have correctly characterised the issue as one of priority."612

a. Undestroyed Proprietary Base

More precisely, the issue falls into a particular class of priority, relating to the concept of the "undestroyed proprietary base". In his judgment, Millett J distinguishes this from "Dearle v Hall" type priority issues, and from tracing.

The natural analysis of the present case is "...as a claim by the original owner to recover his property from a third party who claims to have acquired an interest in the property superior to that of the claimant."613

608 per Millett J at first instance, 752 .
609 at 752
610 (although the reasoning relating in particular to the correct connecting factor differed: see below)
611 "There is at the outset a fundamental disagreement between the parties as to the proper characterisation of the dispute for the purposes of English conflict of laws. The Defendants insist that the question at issue is concerned with the priority of competing interests in a chose in action. Macmillan insists that its claim lies in restitution...". Millett J at first instance, at 757.
612 at 759
613 at 762.
b. Dearle v Hall

In contrast, the type of priority dispute governed by the rule in Dearle v Hall relates to "...successive assignments of the same debt or fund." In other words, the undestroyed proprietary base type of dispute concerns the contest between a transferee and a predecessor in title; Dearle v Hall type claims concern a contest between successive assignees.

C. Tracing

Millett J also distinguishes questions of priority from tracing. He refers to his earlier judgment in El Ajou v Dollar Land Holdings and comments, "In my judgment there is no similarity between the two cases." In other words, "undestroyed proprietary base" type priority disputes concern relative claims of title; tracing concerns identifying the assets to which such title can attach.

If the correct categorisation is priorities, the question remains, priorities in relation to what? The appropriate category for matters concerning securities other than negotiable instruments is that of intangible movables.

614 at 761.

615 "It is probably the case that the distinction between these two kinds of priority dispute corresponds broadly in practice with the distinction between cases which [in English domestic law] are governed by the rule in Dearle v Hall and those which are not" at 762.

616 (1993) 3 All E.R. 717; see also the appeal of the case at [1994] 2 All ER 685 and El Ajou v Dollar Land Holdings plc and another (No 2) [1995] 2 All E.R. 213. The case is discussed briefly in chapter 3 section 7.d.

617 That case was concerned with tracing, not title. It was not disputed that the defendant received the money from the fraudsters ... and that they could not extinguish their victim's beneficial interest in the money of which they had defrauded him. The question was whether the money which the defendant received could be identified with the proceeds of the fraud...The present is the converse case. It is concerned with title, not tracing." At 758, 759

618 Conflicts of law are discussed in relation to negotiable instruments in section F below.

619 See Dicey, volume 2, chapters 22 and 24. It is, of course, somewhat artificial to describe an intangible as a movable, for a thing that occupies no physical space cannot actually be moved from place to place. However, the distinction between movables and immovables is the leading distinction in conflicts of law" (see Dicey, volume 2, p 916) and serves (however notionally) to divide land-related property from other types of property.
The position is governed both by statute and by case law.

3. Statute

a. The Rome Convention

The Contracts (Applicable law) Act 1990 implements the Rome Convention\textsuperscript{620} in the UK. The Rome Convention applies "to contractual obligations in any situation involving a choice between the laws of different countries\textsuperscript{621}.\textsuperscript{622}, subject to various exceptions including ones in favour of negotiable instruments and trusts.\textsuperscript{623} Chapter 4 argued that the interest of a client in the custody securities is that of a beneficiary under a trust. However, the terms of the exception for trusts are confined to the internal constitution of the trust and do not extend to the question of whether transfers of trust units are subject to third party equitable interests.

Article 12 of the Rome Convention provides as follows:

"Voluntary assignments\textsuperscript{624}

1. The mutual obligations of assignor and assignee under a voluntary assignment of a right against another person ("the debtor") shall be governed by the law which under this Convention applies to the contract between the assignor and assignee.

\textsuperscript{620} The Convention on the Law Applicable to Contractual Obligations.

\textsuperscript{621} (Whether or not the countries in question are party to the convention: see Article 2)

\textsuperscript{622} Article 1

\textsuperscript{623} "[The rules of this Convention] shall not apply to:...(c) obligations arising under bills of exchange, cheques an promissory notes and other negotiable instruments to the extent that the obligations under such other negotiable instruments arise out of their negotiable character; ...(g) the constitution of trusts and the relationship between settlors, trustees and beneficiaries...."

\textsuperscript{624} These questions of course concern with contractual, voluntary assignments, rather than with assignments arising by operation of law, for example on insolvency or pursuant to a court order.
2. The law governing the right to which the assignment relates shall determine its assignability, the relationship between the assignee and the debtor, the conditions under which the assignment can be invoked against the debtor and any questions whether the debtor's obligations have been discharged.

To apply these provisions to the integrity of transfers of securities one must look at the nature of transfers.

b. *Contractual and Proprietary Aspects*

A transfer or assignment has two aspects; it is both a contract and a conveyance. The Rome Convention distinguishes between these. Thus, Article 12(1) indicates that the contractual aspects of an assignment, as between the assignor and the assignee, will be governed by the proper law of the contract of assignment625; in accordance with Articles 3 and 4, this will be the law chosen in the assignment626 or, in the absence of such choice, the law of the country with which the contract is most closely connected627, generally the country of central administration of the corporate obligor (transferor)628.

On the other hand, Article 12(2) indicates that the aspects of the assignment that apply as between the debtor and the assignee are governed by the proper law of the transferred property. It is convenient to refer to these aspects as proprietary.629

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625 This accords with the common law rule in *Lee v Adby* (1886) 17 Q.B.D. 309 and *Re Anziani* [1930] 1 Ch 407.

626 Article 3(1)

627 Article 4(1)

628 Article 4(2)

629 See chapter 2 section 3.b for a discussion of the personal and proprietary aspects of choses in action. Under section 3(3)(a) of the Contracts (Applicable Law) Act 1990, the Giuliano-Lagarde Report on the Rome Convention may be considered in interpreting the Convention. This report indicates, on p. 10, that "...since the Convention is concerned only with the law applicable to contractual obligations, property rights... are not covered by these provisions." However, since Article 12(2) concerns the relations between the debtor and the assignee, and since that relationship is proprietary in the sense of being the subject matter of the assignment, the Article must be taken to be an exception to this comment.
The application of Article 12 to the Example must be considered. The legal issue in the Example, and in the whole question of the integrity of transfers, is proprietary: is the transfer subject to pre-existing adverse proprietary claims, or does it overreach them? Article 12(1) cannot be not relevant, as the Example is not concerned with the mutual obligations of the assignor and assignee. Neither, however, is it clear that Article 12(2) is relevant.

c. Different Proprietary Relationships

Dicey extrapolates from Article 12(2) the following rule: "...the validity of the assignment and the obligations of third parties - in other words, all the property aspects of the transaction - are governed by the law under which the right [assigned] was created." This suggests that Article 12(2) governs the position in the Example. However, the terms of Article 12(2) may not be so wide.

Chapter 2 argued that property is relative. Different persons may have competing proprietary rights in an asset. The means by which the courts address competing claims to assets is by considering the priorities between them. In the Example, the claimant does not argue that the transfer to the Custodian was invalid but that the property of the custodian is subject to the competing property of the claimant. As Macmillan indicates, the issue is of one of priorities.

In other words, the issue in the Example is wider than the proprietary relationship between the Custodian and the "debtor." The issue is the

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630 See the first instance decision in Macmillan, in which Millett J refers to "...the intrinsic validity of any of the assignments, its contractual effect as between the immediate parties thereto, or the mutual obligations of assignor and assignee. All such questions are governed by the proper law of the assignment. ... Such questions must be distinguished from questions of priority which are concerned with the proprietary effect of the assignment on the assignor and third parties such as Macmillan claiming under him. An assignment is only a species of contract, and the parties to it can choose the system of law by which they indent their contract to be governed; but they cannot be their contract choose the laws which will govern its effect upon third parties." (at 760)

631 See chapter 2 section 1(e).

633 This is the term used in Article 12 to denote the obligor of the right which is the subject of the transfer.
The application of Article 12(2) to these questions is dubious. It refers to "the relationship between the assignee and the debtor", and not the relationships between the debtor, the assignee and third parties.

4. Case law

Until recently, the non-statutory rules for determining lex causae for questions of priority in relation to intangible movables were highly uncertain. However, the position has now been clarified by Macmillan, in which the Court of Appeal held that the position is governed by lex situs.

5. Lex Situs

Because lex situs governs the possible vulnerability of the custody portfolio to fraud in this way, it is vital to identify the situs or legal location of the custody securities. The Court of Appeal indicated that, in the case of shares, situs will usually be the place of incorporation of the company to which the shares relate. However, where securities are intermediated through global custodial

634 This is the position where there has been no breach of duty by the defendant. If the defendant had defrauded the claimant, the position would differ, for the basis of the claim would rest upon an equitable claim of the claimant as against the defendant. This point is brought out in Macmillan at first instance by Millett J, at 758.


636 "The assignment of intangible things, such as debts, has long been one of the most intractable topics in the English conflict of laws. The writers on the subject are fundamentally divided and the little case law that exists is old, confused and inconclusive." Mark Moshinsky, The Assignments of Debts in the conflict of Laws (1992) LQR 591. See the cautious suggestions in Dicey, volume 1, p. 182 and volume 2, p. 981.

637 (rejecting the first instance reasoning of Millett J that lex loci actus applies). See a discussion of this judgment in 1996 (111) LQR 198-202.
arrangements, and in particular immobilised in a central clearing system. Chapter 7 section C.6 will argue that *situs* is the location of the intermediary.

E. Formalities of Transfer

Chapter 3 considered section 53(1)(c) of the Law of Property Act 1925\(^{638}\), which requires a disposition of an equitable interest to be in writing. It argued that, because of intermediation the interest of the custody client in its securities will in most cases be equitable. However, the secondary markets in Intermediate Securities do not use written transfers. A number of domestic law arguments were cited to show that compliance with section 53(1)(c) may not be necessary. Private international law provides another line of defence against that section.

1. Jurisdiction

The first issue in conflicts is jurisdiction. A French fraudster (acting through its Belgian agent) might transfer French bonds held through Euroclear to a London-based global custodian for the account of its London-based client under an English law oral transfer ("the First Transfer"). The fraudster then purports to transfer the same bonds to a third party under a written English law transfer ("the Second Transfer"). The First Transfer is settled through Euroclear and the bonds are credited to the Euroclear account of the sub-custodian. The transferor goes into insolvent liquidation, and the third party brings an action in England against the global custodian and/or its client for delivery of the bonds, on the basis that the First Transfer is invalid by virtue of section 53(1)(c) ("the Question").

The English courts would have jurisdiction the try the Question on the basis of the domicile or presence in England of the defendant(s).\(^{639}\)

\(^{638}\) (in section 6)

\(^{639}\) Belgium would not necessarily be a more likely forum to be chosen by the claimant, in view of the fact that the claim is based on English law formal requirements.
2. Substance and Procedure

The next problem is whether these formal requirements raise matters of substance or merely of procedure. If matters of substance are involved, the next step in the conflicts analysis will be, as usual, to categorise the matter in order to identify the body of rules that will determine lex causae. However, if these are merely matters of procedure, no categorisation is necessary, for "[a]ll matters of procedure are governed by the domestic law of the country to which the court wherein any legal proceedings are taken belongs (lex fori)." The hope would be to show that matters of substance are involved, in order to avoid the necessary reference to English domestic law (of which section 53(1)(c) forms part.)

Indirect authority on the question of whether section 53(1)(c) raises matters of substance or procedure, is arguably provided obiter dicta in the case of Rochefoucauld v Boustead. The case concerned section 7 of the Statute of Frauds 1677, which required declarations of trusts of land to be evidenced in writing, and which has been replaced by section 53(1)(b) of the Law of Property Act 1925. It might be argued that the drafting of section 53(1)(b) is comparable to that of section 53(1)(c), and that the drafting of section 7 of the Statute of Frauds is comparable to section 9 of that Act, which was replaced by section 53(1)(c). In Rochefoucauld, Lindley L.J. comments, "The statute relates to the kind of proof required in this country to enable a plaintiff suing here to establish his case here. It does not relate to lands abroad in any other way than this. It regulates procedure here, not title to land in other countries."

However, this is not conclusive. The Statute of Frauds imposes formal requirements on a range of different transactions. These requirements fall into two categories, depending upon the sanctions specified for their breach. The penalty for non-compliance with section 4 (parole promises) is merely a bar to enforcement. However, in the case of a larger number of the requirements ("the Second Class"), non-compliance affects the validity of the transaction.

640 Dicey, Rule 17, volume 1, p 169.

641 [1897] Ch 196.

642 at 207
Certain transactions "...shall be utterly void and of none effect"\textsuperscript{643}, others "shall not either in law or equity be deemed to have any other or greater force or effect [than that specified]\textsuperscript{644}, yet others shall not "...be allowed to be good..."\textsuperscript{645}, or are simply prohibited\textsuperscript{646}.

The difference between the two categories for the purposes of conflicts of law is brought out in \textit{Leroux v Brown}\textsuperscript{647}, which concerned section 4. In this case an action was brought by a proposed employee for damages after the repudiation by a proposed employer of an oral contract of employment concluded in France. Under French law the agreement was enforceable although not in writing; section 4 of the Statute of Frauds required a written agreement.\textsuperscript{648}

Thus, section 4 goes to procedure and not substance, and is therefore governed by \textit{lex fori}. However, the basis of this decision is the wording of the statutory provisions: "Looking at the words of the 4th section of the Statute of Frauds, and contrasting them with those of the 1st, 3rd, and 17th sections this conclusion seems to me to be inevitable." Section 4 is procedural because its terms distinguish it from those other sections falling into the Second Class. Section 9 falls into the Second Class, and section 53(1)(c) replaces it.

On this basis, it is submitted that the requirements of section 53(1)(c) are substantive and English law as \textit{lex fori} does not necessarily apply. In order to

\textsuperscript{643} Sections 5, 7 and 9.
\textsuperscript{644} Section 1
\textsuperscript{645} Section 17
\textsuperscript{646} Section 3.
\textsuperscript{648} "...if the 4th section of the statute of frauds applies, not the validity of the contract, but only to the procedure, the plaintiff cannot maintain this action, because there is no agreement, nor any memorandum or note thereof, in writing. On the other hand, ...if the 4th section applies to the contract itself ..., inasmuch as our law cannot regulate foreign contracts, a contract like this may be enforced here. I am of the opinion that the 4th section applies not to the solemnities of the contract, but to the procedure; and therefore that the contract in question cannot be sued upon here. The contract may be capable of being enforced in the country where it was made: but not in England. Per Service J.C. at para 823,4
determine applicable law, the next stage in the conflicts analysis is categorisation.

3. Categorisation

The Question concerns the form and validity of the First Transfer. This is a contract for the assignment of intangible movables. *Lex causae* of the formal validity of contracts of assignment of intangible movables must be established.

4. Formal Validity

Article 9 of the Rome Convention\textsuperscript{649} includes the following provisions:

"*Formal validity*

1. A contract concluded between persons who are in the same country\textsuperscript{650} is formally valid if it satisfies the formal requirements of the law which governs it under this Convention or of the law of the country where it is concluded."

2. A contract concluded between persons who are in different countries is formally valid if it satisfies the formal requirements of the law which governs it under this Convention or of the law of one of those countries.

3. Where a contract is concluded by an agent, the country in which the agent acts is the relevant country for the purposes of paragraphs 1 and 2.\textsuperscript{651}

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\textsuperscript{649} implemented in the UK by the Contracts (Applicable Law) Act 1990.

\textsuperscript{650} "...it is first necessary to describe exactly what is meant by persons being or not being in the same country. If the parties' agents (or one party and the agent of the other) meet in a given country and conclude the contract there, this contract is considered, within the meaning of paragraph 1, to be concluded between persons in that country, even if the party or parties represented were in another country at the time." Guiliano and Lagarde Report. This indicates that the test is presence and not domicile.

\textsuperscript{651} Articles 5 and 6 contain disapplications in favour of consumer contracts and contracts relating to immovable property.
These requirements are disjunctive\(^\text{652}\), and compliance with the formal requirements of any of the specified laws will obviate need for compliance with any other.\(^\text{653}\) Renvoi is not relevant.\(^\text{654}\)

Thus, in the Question, in accordance with Articles 9(2) and 9(3), the First Transfer is formally valid if it satisfies the formal requirements of English law (as the governing law of the transfer or the law of the location of the transferee) or Belgian law (as the law of the location of the agent of the transferor).

Belgian\(^\text{655}\) law does not require a written transfer, and so the First Transfer is valid. Thus the formal requirements of section 53(1)(c) may be avoided, by concluding transfers through agents located in jurisdictions with no equivalent requirements.

5. Mandatory Rules

In the Convention, Article 9 is subject to Article 7(2), which contains a reservation in favour of the application of mandatory rules of the forum.\(^\text{656}\)

\(^{652}\) Arguably this alternative approach reflects the English common law position: see \textit{van Grutten v Digby} (1862) 31 Beav 561.

\(^{653}\) However, other case law suggests that the courts will insist on either one or the other. For the proper law of the chose in action, see \textit{Cia Colombiana de Seguros v Pacific Steam Navigation Co.} [1965] 1 Q.B. 101, per Roskill J. at 128, 129; \textit{In re Queensland mercantile and Agency Co} [1891] 1 Ch 536; [1892] 1 Ch 219 and \textit{Re Fry} [1946] Ch 312. For \textit{lex loci actus}, see the judgment of Scrutton L.J. in \textit{Republica de Guatemala v Nunez} [1927] 1 KB 669, at 688, 690 and 691.

\(^{654}\) The Giuliano and Lagarde Report comments that this generous approach was adopted "...in order to avoid parties being caught unawares by the annulment of their acts on the grounds of an unexpected formal defect. Article 9 has...laid down a fairly flexible system based on applying in the alternative either the law of the place where the contract was entered into...or else the law which governs its substance." "...no priority has been accorded either to the \textit{lex causae} or to the \textit{lex loci actus}. If the act is valid to one of these two laws, that is enough to prevent defects of form under the other from affording grounds for nullity."

\(^{655}\) "Renvoi must be rejected as regards formal validity as in all other matters governed by the Convention" Giuliano and Lagarde Report. (cf. Article 15).

\(^{656}\) Under the Royal Decree No. 62 of 1967, which establishes the regime of fungibility which is the basis of Euroclear.

\(^{656}\) "Nothing in this Convention shall restrict the application of the rules of the law of the forum in a situation where they are mandatory irrespective of the law otherwise applicable to the contract".

- 177 -
"...Of course, under the system established by Article 7, it will be for the court hearing the case to decide whether it is appropriate to give effect to these mandatory provisions and consequently to disregard the rules laid down in Article 9." The issue is then whether the English court will regard the requirements of section 53(1)(c) as a mandatory rule of the forum for the purposes of Article 7(2), and apply them irrespective of the more liberal approach indicated by Article 9(2) and (3) of the Rome Convention. In the case of In re Fry, share transfers were executed in New Jersey by way of gift. The transferor died before consent required by English domestic law for registration of the transfer under the English Defence (Finance) Regulations 1939 was obtained. The argument that the transfer was valid in equity because lex causae was lex loci actus (New Jersey), was rejected. Romer J applied the comments of Turner LJ in Milroy v Lord. "I take the law of this Court to be well settled that, in order to render a voluntary settlement valid and effectual, the settlor must have done everything which, according to the nature of the property comprised in the settlement, was necessary to be done in order to transfer the property and render the settlement binding upon him. ... there is no equity in this Court to perfect an imperfect gift." However, the rejection of lex loci actus in this judgment does not seem to be based on the court's discretion in relation to mandatory rules of the forum, but rather on the rule of equity in relation to voluntary assignments, which is not relevant in the secondary securities markets, where consideration is routinely given.

657 Giuliano and Lagarde Report
The Report goes on to comment, "...despite the opinion of some jurists, it must be frankly recognized that no clear indication in favour of the principle in question seems discernible in the English cases." However, the English cases it cites (Ralli Bros v Sota y Aznar [1920] 2 KB 287; Regazzone v Sethia [1958] AC 301 (H.L.); Rossano v Manufacturers Life Insurance Co. [1963] 2 QB 352) all relate to the rule now contained in Article 7(1) (recognition of mandatory rules of foreign law) rather than to that contained in Article 7(2) (mandatory rules of the forum). Article 7(1) is not incorporated into the law: Contracts (Applicable Law) Act 1990 Section 2(2).

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659 In re Fry, Deceased, Chase National Executors and Trustees Corporation v Fry [1946] 1 Ch 312. This case applied the comments of Turner LJ in Milroy v Lord.

660 at 318.

661 At 315.

662 [1861–73] All ER 783 at 789
Overall, the position is unclear. However, the requirements for written evidence of transactions was imposed by statute in the 17th century\textsuperscript{663} and last addressed by statute at a time\textsuperscript{664} when Parliament could not conceive of a form of information that was neither documentary nor oral. It is therefore to be hoped that the courts would consider that section 53(1)(c) is anachronistic in the electronic era, and does not form part of the mandatory rules of the forum. If so, the requirements for written transfers of Intermediate Securities can readily be avoided under the rules of private international law.

F. Negotiability

Chapter 3 considered the concept of negotiability under English domestic law in the context of global custody. It concluded that the electronic arrangements through which debt securities are held in global custody may have cost them negotiable status under English domestic law. This section will consider whether the rules of English private international law affect the position.

1. Jurisdiction

Section D above considered a scenario ("the Example") in relation to the integrity of a transfer of non-negotiable instruments. In the Example, a third party victim of fraud brings an action in England against a London-based global custodian and/or its London-based client, claiming an interest in French bonds held by the global custodian for the client through a sub-custodian's Cedel account, on the basis that the securities were bought from or through a fraudster. It was seen that the English courts have jurisdiction.

One defence that might be advanced is that the bonds are negotiable, so that the transfer to the sub-custodian was made free of the interest of the claimant. The complication here is that the bonds are immobilised through Cedel. The following sections will take this issue in two stages, starting with the approach of the courts to bearer bonds which are not so immobilised or otherwise

\textsuperscript{663} in the Statute of Frauds Act 1677

\textsuperscript{664} in the 1920s, with the law of Property Act 1925
computerised ("Traditional Bearer Securities") before turning to immobilised or otherwise computerised bearer bonds ("Computerised Bearer Securities").

2. Traditional Bearer Securities

Certain provisions of the Bills of Exchange Act 1882 relate to conflicts of law. However, these provisions are not relevant to this discussion, as they do not concern the proprietary aspects of secondary market transactions.

The common law conflicts rules for determining lex causae for the negotiability of a bearer instrument are as follows. Private international law proceeds by categorisation. As documentary intangibles, bearer instruments are categorised as choses in possession (or tangible movables) and not as choses in action (or intangibles). As choses in possession, the general principle is that the law determining negotiable status is lex loci actus.

3. Transaction not instrument

It follows that the status of negotiability may be said to attach, not to instruments, but to transactions in them, for an instrument may move from country to country, and the question of whether a transaction in it is protected by negotiability depends upon the country in which that transaction takes place.

For the full definitions of these terms, see chapter 3 section A.

Section 72 ("...the United Kingdom is one country for the purposes of the law of negotiable instruments [Bills of Exchange Act 1882]..." Dicey, volume 1, p 26).

Section 72 concerns formal validity, interpretation, duties of holder and due date of payment.


"In the conflict of laws, negotiable instruments are therefore treated as chattels, i.e. as tangible moveables. Whether they are "negotiable" is a question to be determined by the law of the country where the alleged transfer by way of "negotiation" takes place and this is, in the nature of things, the country in which the instrument is situated at the time of the delivery." Dicey, volume 2, p. 1420.

Thus, in Picker v London and Country Banking Co (1887) 18 Q.B.D. 515, Prussian bonds without the coupon sheets attached were held not to be negotiable in England, although they were negotiable by mercantile custom in Prussia. Equally in Lang v Smyth (1831) 7 Bing 284, Neapolitan bordereaux were held not to be negotiable in England because they did not pass from hand to hand in England like money or bank notes. In
On this basis, the crucial issue is not that where the underlying bonds were issued, but where the transaction takes place.671

4. Computerised Bearer Securities

It must be established how this rule applies to Computerised Bearer Securities such as the bonds in the Example.

a. The problem of categorisation672

There are special conflicts rules for negotiable instruments. This raises the following problem. If a matter is categorised as one of negotiability it must be referred to the special rules on negotiable instruments. These rules may indicate that the security in question is not a negotiable instrument, and suggest in turn that a different categorisation may have been more appropriate. In other words, categorisation contains an element of prejudgment. This problem may have been less important when all the securities which were candidates for negotiable status were clearly distinguishable from those which were not (because they were in physical bearer form) and the only variable to be considered was

671 This "transaction specific" approach may be compared to the statutory "several laws" approach to Bills of Exchange: "It is important to realise that a bill of exchange does not contain a single contract but a series of promises to pay made by the acceptor, the drawer and each subsequent indorser, all of which are contained in the same instrument. Section 72 clearly treats each of these contracts as a separate one for the purposes of the conflict of laws and thus adopts what has been called the "several laws" doctrine as opposed to the "single law" doctrine which at one time found favour with English courts in cases decided before the acts." Morris, p 366.

Conversely, if the transaction in question takes place in a foreign country, the negotiable status of the instrument for the purposes of that transaction will be determined by the English courts by reference to the law of that foreign country. In Alcock v Smith [1892] 1 Ch 238 an instrument was sold in Norway at a time when it was negotiable under the law of Norway, but not under the law of England (as it was overdue and, under the Bills of Exchange Act, could only be transferred subject to equities). It was held that Norwegian law governed and the transfer was not subject to the plaintiff's equities.

672 Dicey dryly comments, "The problem of characterisation has given rise to a voluminous literature, much of it highly theoretical. The consequence is that there are almost as many theories as writers, and the theories are for the most part so abstract that, when applied to a given case, they can produce almost any result. They appear to have had almost no influence on the practice of the courts in England. For this reason, no attempt will be made to summarise them in detail..." Volume 1, p 35.
(broadly) the presence or absence of mercantile custom (or statute) conferring negotiable status. However, with the computerisation of the eurobond markets673 this rule of thumb may have broken down.

It would therefore be helpful to be able to show that miscategorisation will have no adverse result, because the rules for negotiable and non-negotiable securities are the same.

The conflicts rules for integrity of transfer in relation to securities other than negotiable instruments were considered in section D above. The leading case in that context is Macmillan674, which concerns shares. Under English law, shares are intangibles, and they are not negotiable.675

The first instance decision in Macmillan was based on a rule in favour of *lex loci actus*; the Court of Appeal upheld the judgment, but on the basis of an alternative rule in favour of *lex situs*. On the facts of that case, the two coincided. It will be submitted that, in the case of Intermediate Securities, the two always coincide, just as they always coincide in the case of Traditional Bearer Securities.

b. *situs of intangible*

Chapter 3 section 4 argued that the interest of a participant in an immobilised clearing system such as Cedel is not the same as the underlying bond. Rather, as an Intermediate Security, it is an interest under a trust. Chapter 7 section C.6 below will argue that the *situs* of

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673 see chapter 3.

674 [1995] 3 All ER 747; 1996 (Court of Appeal).

675 (although shares are negotiable under the law of the State of New York. See the N.Y. UCC section 8-105 and the first instance decision in Macmillan, [1995] 3 All ER 747, at 759 and Colonial Bank v Cady (1890) 15 App. Cas. 267.)
such a trust interest is the jurisdiction of the clearer. On this basis, *lex situs* is Luxembourg law.676

c. *lex loci actus*

The discussions of the New York DTC in the first instance decision in *Macmillan* provide clear authority that *lex loci actus* of settlement by book entry is the law of the jurisdiction of the clearer.677

On this basis, *lex situs* and *lex loci actus* necessarily coincide in the case of Computerised Bearer Securities as in the case of Traditional Bearer Securities. In this way, the old rules may continue to apply in the computerised environment, and the problem of prejudgment referred to in section a above is more apparent than real.

In the Example, the issue of negotiability will be determined by Luxembourg law. In practice, as the approach of Luxembourg law to integrity of transfers generally within its clearing systems is robust. It was seen in chapter 3 section 7.e that, under Luxembourg law,678 the transferee of securities through a depository system such as Cedel is protected against adverse proprietary claims as effectively as if the security in question were a negotiable instrument.679

5. **Conclusions**

As discussed in chapter 3, the computerisation of the bearer bond markets has cost negotiable status. However, under private international law, the benefits of negotiability may still be available in practice, particularly where the

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676 Luxembourg domestic law does not have the concept of an anglo-saxon type trust; however, the notional location of the trust in Luxembourg rests on English private international law. See chapter 7 section [C.6] below.

677 "...my own inclination would be to apply the *lex loci actus*, with the result that the effect on Macmillan's pre-existing interest in the shares of ... the entries on the books of DTC ... would be governed by the law of New York because that is where the entries were made." at 763, 764. See also 768.

678 Article 7 of the Grand Ducal Regulation of 17 February 1971 Modifying the Circulation of Securities

679 Although adverse claims are not necessarily defeated, but rather borne by the depository.
European international clearing systems are involved. This result has been achieved by the convergence of the conflicts rules for negotiable and computerised securities. The usefulness of a separate body of conflicts rules relating to negotiable instruments may be over.680

680 The discussion in this section has concerned the proprietary aspects of transactions in Computerised Bearer Securities. The contractual aspects of transactions in negotiable instruments attract different conflict rules as the Rome Convention is disapplied in respect of "obligations arising under bills of exchange, cheques and promissory notes another negotiable instruments to the extent that the obligations arising under such other negotiable instruments arise out of their negotiable character" Art. 1(2)(c). However, if Computerised Bearer Securities are not negotiable, this difference drops away also.
Chapter 7. Cross Border Proprietary Rights: 
Taking Security and Insolvency

A. General

This chapter considers the challenge presented by two important trends informing the global custody industry: the use of securities as collateral, and intermediation. Market participants are concerned to know with certainty that their collateral is good, and that their assets will survive the insolvency of an intermediary. Such certainty is generally far from achievable and disquiet at this legal uncertainty has been expressed at senior levels for several years; some jurisdictions have led the way with clarifying and reforming legislation. However, the problem is precisely international, and national reform will never provide an adequate solution.

Insolvency and the enforcement of collateral are the two chief occasions when the strength of proprietary claims on assets are tested. The heart of the problem is that different jurisdictions conceive of property in fundamentally different ways, at least where the property in question is intangible, unallocated, intermediated and held cross border, as are the interests of custody clients in their securities. This chapter will consider the

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685 "...the ...claims of customers of a securities intermediary are marked by a lack of control and knowledge and an almost exclusive reliance on the integrity and solvency of the intermediary..." C.W. Mooney, Beyond Negotiability, Cardozo Law Review [1990] Vol 12, 305 at 354.

686 "The many tiers of intermediaries that are typically involved in processing a single securities transaction pose a challenge to the market participant that seeks to be well-informed regarding risk." Bank for International Settlements, Cross Border Securities Settlement, Basle, May 1994, p. 55.

687 See the G10 Report, Cross-Border Securities Settlement (Basle, May 1995): "Choice of law and conflict of laws problems might create uncertainty regarding the finality of transfer, ownership interests or collateral rights. In particular, such problems might complicate the use of collateral to mitigate credit exposures arising in cross-border transactions. In addition, differences in bankruptcy law could result in uncertain or conflicting outcomes regarding the disposition of securities in the event of a counterparty’s or intermediary’s insolvency. Predictability of outcome is essential in efforts to contain financial problems, but widely divergent legal frameworks make predictability hard to achieve in a cross-border context." Recommendation 5 of the Morgan Guaranty Report of 1994, Cross-Border Clearance, Settlement and Custody: Beyond the G30 Recommendations, provides: "Each country should modernise its securities pledging laws to ... include categorical choice-of-law rules assuring respect of the validity of pledges at each tier of a multi-tiered holding system, including tiers governed by foreign laws."

nature of the interest of the custody client under English law, before discussing the wider cross-border issues relating to collateral and intermediation.

B. Nature of Property Interest

Chapter 4 argued that the relationship between the client and the global custodian in respect of securities is likely to be that of beneficiary and trustee.

Private international law as it relates to global custody is very complex. In order to simplify the analysis, certain assumptions will be made. The first is that both the global custodian and its sub-custodians offer fungible custody. Secondly, fungible custody raises issues of allocation, discussed in chapter 5 under the term "the Allocation Problem". It will be assumed that the Allocation Problem is overcome by the co-ownership of the commingled property by the custody clients, under a tenancy in common that arises either under the express terms of the global custody documentation or by operation of law.

On the assumed bases the Custody Trust Asset under English domestic law is in all cases an interest under a trust. Because of the administrative duties of the intermediaries through whom the securities are held, this trust is active and not bare. As the Custody Trust Asset arises under a trust and by way of co-ownership, it is indirect and unallocated. It is, nevertheless, proprietary in the sense that it would not be defeated by the insolvency of the nominee, sub-custodian or depository through whom it is held.

It should be stressed that this is merely the analysis under English domestic law, on the assumed basis. The treatment of the custody assets in the insolvency of a sub-custodian or other local entity in the global network will be determined by the local law of the insolvent entity, which may or may not recognise the English law position, even under English law sub-custody documentation. As a matter of reasonable prudence the global custodian should seek local legal advice as to the effect of the insolvency of a sub-custodian on the custody assets. The analysis in this section is not conclusive, or

689 (i.e. that there is segregation of house positions from client positions, but that the positions of different clients are commingled.) This arrangement is, generally speaking, customary, although not the invariable practice.

690 These assumptions are artificial; there will be cases where client-specific segregation is offered, and there is some remote risk that the Allocation Problem is not addressed in the manner outlined above.

691 i.e. on the assumption of co-ownership between clients under Fungible Custody.
appropriate for risk management: it is rather the basis for the analysis under English private international law that follows, and in particular the discussion of situs in the next section.

C. Taking Security

1. Generally

This section considers the conflicts aspects of the use of securities held in global custody as collateral.

Bonds and shares collateralise much international financing\(^{692}\), as well as the securities settlement systems\(^{693}\). An important growth is derivative margins, and new products are being developed by the clearing systems to deliver securities as margin\(^{694}\).

The granting of security interests over assets held in global custody raises special legal challenges. The secured property often consists of a pool comprising securities issued in different jurisdictions. This pool is usually held through the intermediary clearing systems. In many cases the pool changes from time to time, under substitution provisions\(^{695}\) and mark to market provisions\(^{696}\).

It is important to determine which law will govern the security interest, and whether that law will uphold the security arrangements. This second issue may

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692 Charges over investment securities are of immense importance in international finance, mainly because of the marketability and ease of valuation of the collateral, and also the facility with which investment securities can be made available, usually with a minimum of formality and fuss - in sharp contrast to, say, mortgages of land." Philip Wood, *Comparative law of Security and Guarantees*, London, Sweet & Maxwell, p. 58.

693 "As more payment systems look to securities collateral to control credit risk in the settlement process, those systems also become dependent on the ability to acquire and maintain an enforceable interest in securities." Bank for International Settlements, *Cross-Border Securities Settlement*, Basle, March 1995, p. 46.

694 i.e. as collateral for derivatives exposures.

695 i.e. provisions that the chargee will release charged securities upon the chargor putting up substitute securities.

696 i.e. provision for new collateral to be called and existing collateral to be released to reflect increases and diminutions in the value of the secured obligations. Such provisions are characteristic of derivatives margining.
be divided into four component parts, namely, attachment, perfection, priorities and enforcement.

2. What law will govern?

a. problem with local jurisdiction

Suppose a Euroclear participant wishes to take security over investments held by another participant in Euroclear. The portfolio consists of French bonds. If the chargee is well advised, it will require the security interest to be perfected in accordance with the requirements of Belgian law. If it is cautiously advised, it will also require perfection in accordance with French law, on the basis that the involvement of the French courts may be necessary to enforce the security interest, or defend it against third parties. However, such cautious advice may be harder to follow where the charged property consists of a mixed portfolio of French, Italian, Spanish, German, Honk Kong and New York bonds. The delay and expense of local perfection may be impracticable. It may be commercially impossible in the case of derivatives margining, where collateral turnover may be rapid. The risk that the law of the issuer may govern security interests in the view of courts of competent jurisdiction is a major concern in international secured finance.

b. intermediary jurisdiction

The obvious solution to this problem would be to determine that the charged property, and therefore the security interest, are governed by the law of the intermediary clearer, and not by the law of the local issuer. This approach ("the Intermediary Jurisdiction Approach") informs the concept of a "securities entitlement" in the new Article 8 of the US

697 In this section, "chargee" is used in the widest sense of any person to whom a security interest is granted, and "chargor" is used to mean any person granting a security interest, whether by way of charge, mortgage, pledge or otherwise.

698 such as the liquidator of the chargor, or other creditors, who may seek to attach the charged asset in the hands of the local depository of Euroclear, or even directly against the issuer.
Uniform Commercial Code\textsuperscript{699}. It is advocated more widely in Randall Guynn's paper, Modernising Securities Ownership, Transfer and Pledging law\textsuperscript{700} and developed in section 6 below.

c. defence of security interest

However, the benefit of the Intermediary Jurisdiction Approach may be limited in practice. It may be possible to rely on the cooperation of a clearing organisation in enforcing a security interest over assets held in the clearer and perfected in accordance with the law of the clearer's jurisdiction. Nevertheless, the danger remains that a third party wishing to challenge the security interest (e.g. the liquidator of the chargor or another creditor having a competing security interest in the same assets) may claim the assets in the courts of the underlying issuer, which in turn may make an order against the assets in the hands of the local depositary. The risk, of course, is that while the courts of the clearer's jurisdiction may adopt the Intermediary Jurisdiction Approach, the courts of the issuer may not. For the Intermediary Jurisdiction Approach to be entirely reliable, it must be adopted in every jurisdiction in which the clients of global custody invest. While an EC measure in this context would be most welcome, it would not cure the problem as investment is not confined to the EC. Investment in the emerging markets may increase the risk that security interests perfected at clearer level may be defeated locally.

The ability to defend a security interest at local level may depend on four criteria of local law: attachment, perfection, priority and enforcement procedure. The following sections will consider each of these in general terms\textsuperscript{701}.

\begin{footnotesize}
\begin{enumerate}
  \item Section 8-110 (Transfers) and 9-103(6) (Pledges).
  \item "The process by which a security interest is made to fasten on an asset so as to be enforceable against the debtor as respects that asset is conveniently termed attachment. Attachment is concerned only with relations between creditor and debtor and their respective representatives. It is to be contrasted with perfection, that is, the taking of any additional steps prescribed by law for giving public notice of the security interest so as to bind third parties. Perfection requirements are in turn to be distinguished from priority rules, i.e. rules declaring the
\end{enumerate}
\end{footnotesize}
Attachment

a. managed collateral

Chapter 2 discussed the difference between personal and proprietary rights. A convenient form of shorthand is to consider personal rights as legal relations between persons, and proprietary rights as legal relations between persons and things. Attachment is the legal process whereby a personal right arising under the agreement to grant security is enlarged into a proprietary right, by notionally fixing on the charged asset. Attachment confers a proprietary right on the chargee.

However, this proprietary right is less than full title. The chargor retains a residual proprietary right in the asset, which is the right to have it back upon discharge of the secured obligation. Under English law, this residual property is called the equity of redemption. Thus both the chargor and the chargee have concurrent proprietary interests, legally linking each of them to the same asset.

Broadly speaking, an actively managed portfolio is considerably more profitable than an unmanaged portfolio. If the huge volumes of securities that serve as collateral could not be traded in response to market changes, significant profits would be foregone. It is therefore often provided that collateral securities are not frozen, and that either the chargor or the chargee may deal in them. The chargor is customarily permitted to deal in the collateral securities by substitution provisions, whereby it is allowed to withdraw securities from the collateral pool upon providing substitute securities of equal value and of a type acceptable to the chargee. The chargee is customarily permitted to deal in the collateral

702 The chargee often wishes to use the collateral securities for "on-pledging" (or, in US parlance, rehypothecation), i.e., as collateral to third parties to secure its own obligations. US law is more comfortable with these arrangements than English law because of the liberal provisions of Article 9 of the UCC.

703 For a discussion of substitution rights in relation to collateral, see Philip Wood, Comparative Law of Security and Guarantees, p. 63.
securities by equivalent redelivery provisions, whereby its duty upon the
discharge of the secured obligation is to not to redeliver the very
securities that were delivered to it by way of collateral, but to deliver
securities of the same number and type. However, both substitution and
equivalent redelivery are legally problematic.

English law has the concept of a floating charge, whereby security may
be given over a changing pool of assets, with the chargor retaining
freedom to deal in the ordinary course of its business. However, floating
charges are generally registrable\footnote{Under the Company Act 1988 Section 395. In many security arrangements, the formality and publicity involved in registration would be commercially unacceptable. UK banks are prevented from giving floating charges by the Bank of England.}, and rank lower in priority to fixed
charges.\footnote{(and are frozen on administration together with other disadvantages)} It is possible to create a fixed charge over a changing pool
of assets by conditioning the right of substitution of the chargor, but this
is incompatible with an unrestricted freedom to deal. Other
jurisdictions\footnote{particularly civil law jurisdictions.} have no concept equivalent to the floating charge; a
security interest purportedly given over a changing collateral pool might
simply not attach. The risk, therefore, of permitting the chargor freedom
to deal in the collateral is that the security may be defeated, for want of
attachment under civil law, and for want of registration under English
law.

For these reasons, it is more customary for the title to economic assets
represented by the management potential of the collateral pool to be
conferred on the chargee, through equivalent redelivery provisions. On-
pledging has a long history, and is customary in the United States.
However, under English law, it raises the following problem. If the
chargee may deliver back securities which are different from those
provided by the chargor, and may dispose of the original securities free
of any interest of the chargor, the chargor can retain no equity of
redemption. If the securities it receives back are or may not be the same
ones it put up, it has no continuing proprietary interest in them. The
transaction is not the granting of security, but an outright transfer.
To summarise, the problem with permitting the chargor to deal is that the chargee's rights may not attach; the problem with permitting the chargee to deal is that the chargor's rights may not persist. For ease of reference, these two problems together will be referred to as the "Attachment Problem". A security interest involves the creation of concurrent proprietary interests in the chargor and the chargee; the need for a proprietary interest to be linked to an asset requires the charged asset in effect to be frozen between them. Thus, traditional concepts of security will inevitably be problematic in an environment where the freezing of large portfolios of securities is uneconomic.

The markets have therefore sought out ways of providing collateral otherwise than by way of security. The chief example is the growth of repurchase agreements ("repos"). Under these arrangements, collateral is provided by way of outright transfer, subject to contractual redelivery obligations. No security interest is taken, and counterparty risk is addressed by a set off mechanism that is triggered by default. The same structure is adopted in stocklending and sale and buy back arrangements.

The phenomenal growth of the repo market in recent years is certain to continue, as repos provide the natural answer to the Attachment Problem by substituting contractual for proprietary rights. In some respects the Attachment Problem (which arises when security is taken) is akin to the Allocation Problem\(^707\) (which arises when proprietary rights are intermediated). Both derive from the need for property to inhere in particular assets, and both present difficulties in modern custodial practice where the trend is generally away from allocation and towards pooling. Chapter 5 considered how the Allocation Problem can be addressed by the concept of co-ownership. Co-ownership cannot cure the Attachment Problem, because of the need for collateral assets to be sold free of any encumbrance. The contractual set-off route adopted in repos cannot cure the Allocation Problem, for the simple reason that the exposures of investors to the intermediaries holding their securities are not matched by mutual obligations capable of set off. With intermediation, the exposure

\(^707\) discussed in chapter 5
is all one way, so the concept of property is necessary to address insolvency risk.

b. *English law*

The English conflicts rules for the attachment of security interests may be summarised as follows.

The contractual aspects of an agreement to grant security are governed by Rome Convention\(^7\)\(^0\)\(^8\). However the Rome Convention does not cover proprietary rights.\(^7\)\(^0\)\(^9\) The effect of attachment of a security interest over the custody portfolio is to transfer to the chargee a proprietary interest in the portfolio. The position is likely to be governed by the non-statutory conflicts rules for the assignment of intangibles.\(^7\)\(^1\)\(^0\)

While these are complex, Dicey indicates that they produce the same result as the Rome Convention.\(^7\)\(^1\)\(^1\) This is summarised as follows: "...the mutual obligations of the assignor and assignee are governed by the law applicable...to the contract between them while the validity of the assignment and the obligations of third parties - in other words, all the property aspects of the transaction - are governed by the law under which the right was created."\(^7\)\(^1\)\(^2\) On this basis, while the contractual validity of a security interest\(^7\)\(^1\)\(^3\) will be determined by the governing law of the contract\(^7\)\(^1\)\(^4\), the attachment of a security interest to French Traditional

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\(^7\)\(^0\)\(^8\) The Convention on the Law Applicable to Contractual Obligations, implemented in the UK by the Contracts (applicable Law) Act 1990.

\(^7\)\(^0\)\(^9\) "...since the Convention is concerned only with the law applicable to contractual obligations, property rights...are not covered by these provisions." p 10, Giuliano and Lagarde Report

\(^7\)\(^1\)\(^0\) "The assignment of intangible things, such as debts, has long been one of the most intractable topics in the English conflict of laws. Mark Moshinsky, *The Assignment of Debts in the conflict of Laws*. The Law Quarterly Review, 109, p. 591.

\(^7\)\(^1\)\(^1\) Volume 2, p. 979.

\(^7\)\(^1\)\(^2\) p 979, 980 See *Re Fry* [1946] Ch 312.

\(^7\)\(^1\)\(^3\) or at least one created by contract

\(^7\)\(^1\)\(^4\) i.e. the contract creating the security interest
Bearer securities will be governed by French domestic law. The law
governing the attachment of a security interest to such securities when
they are immobilised in Cedel will depend upon whether the charged
asset consists of French law bonds or a Luxembourg law interest in such
bonds. This issue is discussed in detail in section 6 below. An
alternative view is that the position is determined by lex situs\(^{715}\). The
two will often coincide in practice.

4. Perfection

a. generally

An attached security interest generally survives the insolvency of the
chargor\(^{716}\) and therefore addresses credit risk. However, it may not
address the risk the chargee may double deal, and that a third party may
claim the charged assets, for example under a court order or pursuant to
a sale or a subsequent security interest. In order to bind third parties,
different systems of law prescribe certain acts of perfection, or the giving
of public notice.

The perfection requirements of English domestic law are few, although
the Companies Act 1985 imposes strict registration requirements on
corporate security interests\(^{717}\). However other countries, particularly civil
law jurisdictions, may impose expensive and time consuming formalities,
including notarisation.

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\(^{715}\) The *lex situs* is the basic choice of law rule for property in the conflict of laws, applying to tangible movables
and immovable property alike. The *lex situs* has the virtue of simplicity in having the same rule apply for all
types of property. The *lex situs* would in general seem to provide a satisfactory and appropriate rule to govern
the transfer of property in a debt from the assignor to the assignee. Moshinsky, op. cit., pp. 607, 609. It is
clear that *lex situs* governs transfers of negotiable instruments: *Alcock v Smith* [1892] Ch. 238; *Embricos v

\(^{716}\) assuming of course that it is a valid and enforceable security interest. This is because, as between the chargor
(and its representatives including its liquidator) and the chargee, the security interest is proprietary and not
merely contractual.

\(^{717}\) Section 395. Breach of these requirements defeats the security interest against the liquidator or any creditor
of the chargor, so the requirements go both to attachment and perfection.
Where security is taken over an international portfolio, it would often be impracticable to perfect in the jurisdiction of each issuer of the component securities. Where the collateral pool changes, so that securities of any one jurisdiction may enter and leave it from time to time, compliance with all local perfection requirements may be out of the question.

However, the risk cannot be excluded that the courts of any issuer jurisdiction would treat its local perfection requirements as applicable. The important question then is, will the chargor be exposed to the decision of such courts? It might either if their cooperation is required in enforcing the security interest, or in defending the security interest against the competing claims of other creditors or the liquidator of the chargor.\footnote{Macmillan judgment. Perfection is governed by the \textit{lex situs}.}

5. Priorities

a. \textit{generally}

Once a security interest has cleared the hurdles of attachment and perfection, it may then need to compete with other security interests that have also done so. The outcome of that competition depends on rules of priority. Chargees may routinely take representations of no prior encumbrance and negative pledges against subsequent encumbrances. However, these may not be entirely reliable\footnote{Breach of representation and negative pledge will not necessarily defeat a competing interest.}, and the rules of priority will therefore be of concern.

It would be prudent to assume that local courts may apply the rules of the forum to questions of priority. Where security is taken over an

\begin{itemize}
    \item \footnote{see the discussion in section 2 above}
\end{itemize}
international portfolio, it is important to seek to identify the courts in
which the security interest may require to be defended, and to consider
the priority rules of those jurisdictions. The issuer jurisdiction is
obviously important, as third parties might seek to attach the charged
assets there.

b. English law

Priority rules under English private international law were considered in
chapter 6 section D above. Two different rules apply, depending on
whether the claim of the plaintiff in the action concerns double dealing,
or breach of fiduciary duty. In the first case, where security interests in
the same property are granted first to A and then to B, the general rule
is to apply lex fori. However, where the charged property is a debt
or (probably) other choses in action such as an interest in a security, the
position is less clear. There is authority that priorities are governed by
the law governing the chose in action. There is conflicting authority
that priorities are determined by lex situs. Thus, if A charges French
bonds held in Euroclear first to B and then to C, priorities between B and
C will (in an English court) be determined either by French law or by
Belgian law, depending on the view taken by the court of the nature or
location of the asset charged. For further discussion of this question, see
section 6 below.

In the second case, A holds the bonds as fiduciary for B, and charges
them to C in breach of fiduciary duty. As discussed in chapter 6 section
D above, the position is governed by the rule in Macmillan, which is that
priorities are determined by lex situs.

6. Intermediary Jurisdiction Approach

Bankers Trust international Ltd. v Todd Shipyards Corp. (The Halcyon Isle) [1988] A.C. 221, 230-231. These
cases concern the priorities in relation to a marriage settlement, and ships.

721 Le Feuvre v Sullivan (1855) 10 Moo.P.C. 1; Kelly v Selwyn [1905] 2 Ch. 117; Republica de Guatemala v
Nunez, [1927] 1 K.B. 669

722 See Re Queensland Mercantile and Agency Company quoted in footnote 48 of Moshinsky, Assignment of Debs,
Law Quarterly Review, 109, 591
Section 2 above considered the problem of taking security over international portfolios, and the consequent exposure to the demands of a number of different legal jurisdictions. It suggested that the Intermediary Jurisdiction Approach, whereby the charged asset is treated as being located in the jurisdiction of the intermediary, would help by consolidating the legal requirements for taking good security into those of the law of the clearer (although all courts of competent jurisdiction must recognise this approach before it is entirely reliable). This section will argue that the Intermediary Jurisdiction Approach is already implicit in English law, and may not require to be introduced by legislation.

Section B of this chapter considered what the interest of the custody client is, and suggested that the English courts will characterise this interest as being, or as being akin to, an interest under a trust. This section will consider where it is.

a. *lex situs*

This section will argue that, where securities are held by intermediary custodians and clearing systems, the situs of the interest held by the intermediary is the jurisdiction of the intermediary. Such a situation would be important in addressing conflict of law risk, as under many systems of private international law proprietary interests including security interests are determined by *lex situs* of the charged asset. Under English conflict rules, *lex situs* is also important, for a number of reasons.

Firstly, jurisdiction. Broadly speaking, in matters involving European defendants, the English courts generally have jurisdiction in claims concerning a trust domiciled in England.723 Where the defendant is domiciled in Scotland, Northern Ireland or outside Europe, the English courts have jurisdiction over matters concerning moveable property.
situated in England. These rules may assist in avoiding litigation in issuer jurisdictions. Secondly and more importantly, attachment and priorities may be determined by *lex situs*.

In the English courts, *lex situs* will be determined in accordance with English law.

b. *intangibles and securities*

Attributing a location to an intangible such as an interest under a trust is a notional exercise. Of course, the intangibility of some securities predated computerisation and global custody. As discussed in chapter 3, traditional registered securities have always been intangible. That section also argued that securities held through computerised clearing systems are a form of registered security, the register being the database of the clearer. Traditionally, *situs* of registered securities is the location of the register.

c. *interest under a trust*

Global custody and more generally the computerisation of securities, involves intermediation, so that the interest of the custody client in the custody securities is no longer direct. Section B argued that the process of intermediation changes the legal nature of the client's proprietary interest, so that on the assumed bases the Custody Trust Asset is an interest under a trust. The *situs* of such an interest must be established.

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725 see chapter 6 sections B.1.d and B.2.c

726 See sections C.3 and C.4 above.

727 "In the conflict of laws the *situs* of a thing is ascertained by reference to the rules of the *lex fori* because all concepts signifying connecting factors must be interpreted by reference to that system." *Dicey*, Volume 2, p 923.

728 (in section D)

729 *Dicey* p. 931.

730 on the assumption of co-ownership between clients under Fungible Custody.
This question was considered in the context of a trust of a portfolio of securities in *In re Cigala's Settlement Trusts*[^731]. In this case, under a marriage settlement executed in England, a wife settled a portfolio of French and English securities on trust, after the death of the survivor of husband and wife, for their children. The trustees were English. Succession duty would have been payable if the property to which the children became entitled was English property. It was held that succession duty was payable[^732]. The case suggests that the interposition of a trust between underlying property and its beneficial owners may move the situs of that property to the location of the trustees.

Further support for this view is provided by *A. G. v Johnson*[^733]. The slightly simplified facts are as follows. An English domiciled testator left a tea estate in Assam on trust with English resident trustees. Two of the beneficiaries died, thereby increasing the share of the survivors. It was necessary to determine the situs of this increased share for taxation purposes. It was held that the increase did not constitute property situate out of the United Kingdom so that succession, estate and settlement estate duty were payable. The decision was based on the fact that English trustees stood between the beneficial owner and the underlying property[^734].

The theme is continued in the case of *Favorke v Steinkopff*[^735]. English trustees were directed to invest a certain sum in German Securities. The beneficiaries were German nationals. It was held that the interests of the

[^731]: (1878) 7 Ch. D. 351

[^732]: See Jessel, M.R. at 355.

[^733]: [1907] 2 K.B. 885

[^734]: "I think it is clear that, but for the intervention of the trustees and the special directions and powers given to them the property would have been situate out of the United Kingdom. (per Bray J at 893.)"

[^735]: [1922] 1 Ch. 174
beneficiaries were charged under the Treaty of Peace Order 1919 as being "property, rights and interests" in the United Kingdom." 736

In all of these cases, the situs of the interest of a beneficiary under a trust is the location of the trustee.

d. Enforcement Procedure

Chapter 2 considered the nature of proprietary rights. It argued that property is, in origin, a remedy, and that the legal nature of property is deeply coloured by the court procedures whereby proprietary remedies may be obtained. 737 It should therefore be no surprise to find that the basis for the above judgments is procedural. The right of the beneficiary in respect of the underlying property is (in the absence of breach of trust) 738 not directly enforceable against that property. It is only enforceable through the trustee. 739 More generally, an important jurisprudential basis for the rule that proprietary rights are determined in accordance with lex situs, is the pragmatic consideration that the cooperation of the courts where the assets are located will be required for enforcement. In practice, the primary recourse of the custody client is against the trustee. These are arguments in favour of identifying lex situs as the jurisdiction of the trustee.

736 See Russell J at 177.

737 See chapter 2 section 1.1

738 (when tracing may be available to beneficiaries)

739 "Maak's right is a right against the trustees, a right to call on them to do their duty under the will, and, if they do not, to come to the Court here and ask to have the estate administered according to the trusts of the will. That right seems to me to be a chose in action, and a chose in action must be regarded as situate in the country where it is enforceable." Favorke v Steinkopff, per Russell J at 178. This is again emphasised in A.G. v Jewish Colonisation Association [1901] 1 K.B. 123: "...where property is found to be legally vested in a person subject to the jurisdiction of English Courts, ...the title to the beneficial interest in that property is regulated and capable of being enforced by the laws of England..." (per Stirling L.J. at 142).
Chapter 2 considered the difference between personal and proprietary rights. It argued that the question of whether a right is proprietary, makes little sense when considered in abstract terms, and is meaningful only in the context of concrete situations, the most important of which (in the modern era) is insolvency. It also argued that equitable interests arising under trusts lie on the border between personal and proprietary rights. Trusts comprise a broad category of legal arrangements, ranging from bare trusts (where the beneficiary has allocated property rights in the trust assets)\(^{740}\) to unadministered estates (where no property rights in favour of the beneficiary can arise because of want of allocation), and the right of the beneficiary is merely personal against the trustee.\(^{741}\) However, all trust interests are proprietary in the important sense that the beneficiaries' rights are not vulnerable to the insolvency of the trustee. However, these rights are indirect, for (in the absence of breach of trust) they are not enforceable by the beneficiary directly against the trust assets.\(^{742}\) It might be said that trust interests are proprietary in the trustee's insolvency, and personal in enforcement against third parties. All trust interests share this hybrid nature. In locating their situs with the trustee the cases discussed in this section, the English courts have been guided by the nature of trust interests in third party enforcement.\(^{743}\)

f. Allocated and Unallocated Interests

This chapter has assumed Fungible Custody at the level of the sub-custodian, with the result that the Custody Trust Asset is unallocated.

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\(^{740}\) See also A.G. Hong Kong v Reid [1994] 1 All ER 1, where a trust interest is held to be proprietary and cautionable against underlying land.

\(^{741}\) See Webb v Webb [1994] 3 All ER 911 for the characterisation of trusts interest as personal rights. Baker v Archer-Shee discusses the difference between a mere chose in action against the trustee and rights in rem against the underlying assets. See also Hayton, The Law of Trusts, pp. 161-163. See also Marshall v Kerr [1994] 3 All ER 106 at 119.

\(^{742}\) Enforcement must generally be through the trustee as legal owner of the assets. Thus, the beneficial owner of shares generally cannot compel the issuer to pay the dividends to him, without joining the trustee of the shares.

\(^{743}\) (The English courts have also been guided by the nature of trust interest in third party enforcement in determining the question of jurisdiction.)
This is important, as it is arguable that the rules for attributing situs to an interest under a trust differ depending on whether the interest is allocated or unallocated.

Lord Sudeley v Attorney General\textsuperscript{744} begins a long line of cases concerning the situs of another class of unallocated trust interests, namely interests in unadministered estates. In Lord Sudeley, an English domiciled testator left one quarter of his residuary estate to his wife absolutely. His wife died domiciled in England before the husband's estate was fully administered or the residue ascertained. The residue included mortgages on real property in New Zealand. It was held that estate duty was payable on that part of the wife's estate referable to the mortgages as the property was an English asset. This was because the wife's interest in the residuary estate was unallocated.\textsuperscript{745}

In this case, it was held that because the interest was not merely unallocated, but it was not proprietary at all but merely a personal right of enforcement against the trustee.\textsuperscript{746} In this respect, the cases differ from Fungible Custody, under which (on the basis assumed in this chapter) the interest of the client is proprietary.

Lord Sudeley was directly followed in the cases of In re Smythe\textsuperscript{747} and Commissioner of Stamp Duties (Queensland) v Hugh Duncan Livingston\textsuperscript{748}. In these cases, the interest in question also arose in an unadministered estate, and there was no indication that the interest in question was proprietary.\textsuperscript{749} However, in the case of Baker v Archer-

\textsuperscript{744} 1897 A. C. 11

\textsuperscript{745} per Lord Davey at 21.

\textsuperscript{746} "I do not think that they [the wife and her executors] have an estate, right, or interest, legal or equitable, in these New Zealand mortgages so as to make them assets of her estate." per Lord Herschell at 18. See also Lord Davey at 21.

\textsuperscript{747} In re Smythe, Leach v Leach [1898] 1 Ch 89.


\textsuperscript{749} Chapter 2 section 1.h argued that the interest under a beneficiary in an unadministered estate is merely an equitable chose in action and not an equitable chose in possession.

- 202 -
Shee\textsuperscript{750}, the position more closely accorded with that under Fungible Custody, as the case concerned an estate that had been administered.

In this case, a US testator left foreign securities under a US trust for his daughter for life. The trustees were a US trust corporation. Income was not remitted to England but held in an account in New York. Archer-Shee, the husband of the daughter, was assessed to income tax on the income of his wife on the basis that it was income arising from foreign securities (which was taxable whether or not received in the UK). Archer-Shee argued that, because of the interposition of the trust, it was income from a foreign possession other than stocks and shares (which was only taxable to the extent it was remitted to the United Kingdom).

The House of Lords held that the income was taxable.\textsuperscript{751} The daughter was specifically entitled to the income and had an allocated interest in the underlying property under the terms of the trust. The Master of the Rolls in the lower court had relied on the principle of Lord Sudeley to hold that tax was not payable. However, Lord Sudeley was distinguished, because in this case the estate had been administered.\textsuperscript{752}

There is obiter authority that, had the daughter’s interest been proprietary but unallocated, the judgment would have differed.\textsuperscript{753} Also of interest are the dissenting judgments of Viscount Sumner and Lord Blanesburgh, who argue that, even though allocated, the daughter’s interest is indirect and therefore not the same as a direct proprietary interest in the underlying property.\textsuperscript{754} The trust in question was a New York law

\textsuperscript{750} (H. L) [1927] A.C. 844.

\textsuperscript{751} (Viscount Sumner and Lord Blanesburgh dissenting).

\textsuperscript{752} “My Lords, with great respect to the Master of the Rolls, I do not think either his own reasoning or the quotations he relies upon have any application to a case such as the present when, as I have already pointed out, we are dealing with “a definite and specific trust fund.” Per Lord Carson at 871. See also Lord Atkinson at 862 and Lord Wrenbury at 866.

\textsuperscript{753} “...had the share to which Lady Archer-Shee was entitled been a proportion only of the income or profits of the residue other questions would, no doubt, arise.” Per Lord Carson at 869.

\textsuperscript{754} “All that she has is a right, in the forum of the trustee and of the trust fund, to have the trust executed in her favour under an order to be made for her benefit by the appropriate Court of equity, and this “possession” neither consists in the trust’s investments or any of them nor is it situated here. It is “foreign”. ” Per Viscount
trust, and New York law was presumed to be the same as English law. However, further assessments to tax were made on Archer-Shee, and in a later case (*Archer-Shee v Garland*) he adduced expert evidence that New York law differed from English law in that his wife did not have an estate or interest in the underlying securities, but only a chose in action against the trustees. On this basis it was held that tax was not payable.

These cases help to formulate the rule that the situs of trust interests which are unallocated but proprietary (as in Fungible Custody on the assumed bases), is the jurisdiction where the trustee is located.

g. *situs of underlying property*

A different approach is suggested in *Dicey*. This approach seeks to distinguish between trust interests which are proprietary interests in the trust assets, and those which are mere choses in action against the trustee. (This chapter has argued that all trust interests are both of these things.) *Dicey* argues that the rule for the situs of a trust interest differs according to which class it belongs to. "If the beneficiary is given a beneficial interest in the trust property then his interest under the trust is located in the country where the trust property is situated. If the beneficiary is given merely a right of action against the trustees then his interest under the trust is located where the action may be brought, i.e. at the trustees’ place of residence." 756

Only two cases are cited in support of the first part of the rule (that situs of the interest coincides with that of the underlying property), namely *Re Berchtold* 757 and *Phillipson-Stow v I.R.C.* 758. Both of these concern the private international law of succession. The outcome of each case

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depended upon whether, upon succession, an interest in land held on trust for sale was movable or immovable property. In both cases such interests in freeholds were held to be immovable. As the scope of the definition of immovable property is extremely wide and somewhat arbitrary\textsuperscript{759}, these cases do not provide clear authority for location of any proprietary interest under a trust in the jurisdiction of the underlying assets\textsuperscript{760}.

A larger number of cases are cited in Dicey in support of the rule that situs of the trust interest coincides with that of the trustee. This chapter has argued that this rule is correct, and applies to all trust interests, on the basis of the manner in which they are enforceable.

\textbf{h. conclusions}

In conclusion, it is argued that \textit{lex situs} of an unallocated trust interest such as the interest of the custody client in the Custody Trust Asset, is the law of the jurisdiction of the trustee\textsuperscript{761}. In other words, the way in which securities are held determines not only their legal nature but also their legal location.

This approach is clearly advantageous in the context of global custody, for there will be only one trustee (and therefore only one \textit{lex situs}). In contrast, identifying \textit{lex situs} with the situs of the underlying assets, will

\begin{itemize}
\item \textsuperscript{759} ("A mortgage debt secured by land is immovable property": \textit{In re Berchtold}, per Russell J, at 201)
\item \textsuperscript{760} It may be proper to distinguish between movable and immovable property; the importance of the location of the underlying property is greater in the latter case. See D.W.M. Waters, \textit{The Law of Trusts in Canada}, 1974. Carswell, Toronto, p. 969: "...where immoveables are concerned, the \textit{lex situs} will continue to have an overwhelming and inevitable influence...where a trust comprises both movables and immoveables ...there is good reason for not giving such an influence to the \textit{lex situs} ...because it should be a matter of importance that the trust should be seen as a unit and its issues dealt with accordingly..."
\item \textsuperscript{761} Support for this view is found in Philip Wood, \textit{Comparative Law of Security and Guarantees}, London, Sweet & Maxwell, 1995, p. 190: "The \textit{lex situs} of fungible securities deposited with a custodian ought to be the office of the custodian where the securities account is kept". See also p. 81
\end{itemize}
produce a fragmented approach in the case of a mixed portfolios that are characteristic in global custody.762

However, the benefit of the approach remains limited by forum risk.

7. Forum Risk

While the Intermediary Jurisdiction Approach may be the way forward for the use of custody securities as collateral, the problem remains that a forum such as that of the issuer of the securities may assume jurisdiction, and adopt a different approach.

The difficulty of the legal position, and the commercial imperative of using securities as collateral, call for a pragmatic approach. Chargees will often have to tolerate some measure of legal risk, and should focus upon practical issues relating to enforcement. Possession is of primary importance. Will the intermediary clearer or custodian cooperate in enforcing the security interest sufficiently rapidly, so that challenge at issuer level may come too late? Does the clearer have more than one local depositary, so that a third party claiming a competing right in the charged assets would be unable to identify and therefore attach the charged assets through the local courts? Finally, and subject to the need to avoid illegality, does the chargee have any assets of its own in the issuer jurisdiction against which adverse claims or penalties might be enforced?

D. Insolvency

1. Cash and Securities

762 This sort of fragmented result was judicially rejected in the slightly different context of integrity of transfer. In the first instance judgment of Macmillan v Bishopsgate Investment Trust plc, (No. 3) [1995] 3 All ER 747. Millett J refers to "...cases like the present in which portfolios of securities are delivered which consist of shares of companies in many different countries. ... when it comes to considering whether any and if so what inquiries the recipient ought to make in order to verify the right of the transferor to deliver the portfolio, it would in my judgment be absurd to distinguish between the different components of the portfolio unless and until the recipient himself differentiates between them by attempting to perfect his security." at 763. See also Moshinsky, op. cit., pp. 605, 611 and 613.
Custodian insolvency is complicated by the fact that global custodial arrangements are intermediated and cross-border. However, this is only true in relation to the securities in the custody portfolio. As discussed in chapter 6 section A.2, custody cash balances are neither intermediated nor cross-border, for they are not proprietary.\footnote{In general, the custody cash balance represents the unsecured debt of the custodian to the client. Because the client’s claim is personal against the custodian and not proprietary, the client takes the custodian’s credit risk. The legal analysis is simple, as the client does not look beyond the custodian to other persons in other jurisdictions in order to assert proprietary rights against them.}

Where the global custodian becomes insolvent, the client’s cash balances will generally\footnote{(unless a special arrangement has been established, such as a client money trust with a third party bank, a “near cash” arrangement such as a Short Term Investment Fund, or comparable arrangements rendering the claim of the client proprietary). Following the Barings crisis, innovative work was done in developing such arrangements.} be at risk as unsecured debt. However, if a sub-custodian becomes insolvent, the client’s cash balances will not generally\footnote{(in the absence of contractual provision to the contrary in the global custody agreement)} be affected, as the global custodian’s obligation to pay is not conditional on its ability to recover from sub-custodians.\footnote{(although its inability to recover from sub-custodians may trigger its own insolvency). In commercial effect, the global custodian guarantees the cash positions with the sub-custodians. Legally, of course, it is not a guarantee but a primary obligation.}

The comments in the remainder of this section relate to custody securities.

2. Intermediation

The growth in cross-border investment implies greater use of intermediaries in the custody of securities, as the need for liaison with local issuers and tax authorities necessitates the use of local sub-custodians. A second reason for the growth of intermediation is settlement. Much of the risk and inefficiency in the securities markets is associated with settlement. The need to address settlement difficulties is one of the driving forces for innovation in the securities markets. The problem is simple. On the one hand, transferring securities in certain markets involves risk, expense and delay. On the other hand, investors need to be able to buy and sell their beneficial interests in securities safely, cheaply and quickly. One solution has been used again and again: the removal of settlement from the problematic forum of the issuer of the underlying securities, to the safe and convenient forum of an intermediary. Whether securities are
repackaged in depositary receipt form\textsuperscript{767} or immobilised in a clearing system\textsuperscript{768}, the fundamental idea is the same. Large numbers of securities are transferred into the name of an intermediary institution and held by it for participating investors; transactions between participants are settled by amending the records of the intermediary, thereby avoiding the need for settlement in the local markets. One level of intermediation may be introduced by repackaging, another by immobilisation, and yet others by the need to have a lead custodian in the jurisdiction of the client, and a further custodian in the jurisdiction of the issuer of the underlying securities. The investor may be separated from the underlying securities by a chain with a significant number of links.

However, if intermediation reduces settlement risk, it introduces risks of its own: investors' securities may be lost in the hands of intermediaries for a variety of reasons, including fraud\textsuperscript{769}. However, a study of the London markets\textsuperscript{770} has shown that losses of client securities in the hands of intermediaries have not been caused by fraud alone\textsuperscript{771}, but by the combination of fraud and insolvency\textsuperscript{772}. In the worst case, the assets are not there, and there is no-one to sue for their recovery. Both the investor's proprietary rights and its personal rights\textsuperscript{773} in respect of its investment are valueless.

Intermediary risk is the risk that custody securities in the hands of the insolvent intermediary may be available to its general creditors; this is a question of law. Shortfall risk is the risk that there is a shortfall in the intermediary's holding of custody securities; this is a question of fact. Sections 3 to 6 will look at intermediary risk and section 7 will consider shortfall risk. Sections 8 and 9 will address other risks to the custody assets on

\textsuperscript{767} see chapter 10
\textsuperscript{768} see chapter 11
\textsuperscript{769} \ldots the involvement of intermediaries in the holding of securities and the settling of trades necessarily creates new legal relationships and new risks. Perhaps the most basic difference in risks is that the non-resident faces custody risk - the potential loss of the securities held in custody in the event that the local agent becomes insolvent, acts negligently or commits fraud." Bank for International Settlements, Cross-Border Securities Settlement, Basle, May 1995, p. 22.
\textsuperscript{771} presumably because, provided the intermediary is solvent, there will be an enforceable obligation on the intermediary to make up the shortfall.
\textsuperscript{772} see p. 3, Custodianship and the Protection of Client Property.
\textsuperscript{773} (against the custodian)
insolvency (liens and liquidator’s costs). Finally, section 10 will consider insolvency conflicts of law.

3. Intermediary risk

Chapter 2 indicated that the chief practical difference between personal and proprietary rights is that personal rights may become valueless in the insolvency of the obligor. In the context of custody, it is important to establish that the client enjoys proprietary rights in the custody securities, so that it is not exposed to the credit risk of any intermediary. Proprietary rights link a person to an asset. In order to be linked to the underlying custody securities, the client must demonstrate that its property runs through each link in the chain of intermediaries though which the securities are held. Its proprietary claims are as weak as the weakest link.

Suppose an English investor appoints a London global custodian to hold its Italian bonds. The bonds are held through Euroclear, of which the global custodian is not a participant. This means that the custody chain will have 4 links. The investor delegates safekeeping to the global custodian. The global custodian sub-delegates custody to a Belgian sub-custodian which is a Euroclear participant. The sub-custodian delegates to Euroclear. Euroclear does not hold the bonds itself, but sub-delegates custody to an Italian depositary, which holds the bonds in its vaults. The global custody agreement is governed by English law. The sub-custodian agreement, Euroclear’s general terms and conditions and the depositary agreement are governed by Belgian law. The bonds are governed by Italian law.

In order for the client to own the bonds, each link in the chain must pass proprietary rights upwards to the next intermediary. It may be assumed that the depositary will own the bonds under Italian law, by virtue of possession (in the case of bearer bonds) or registration (in the case of registered bonds). Whether Euroclear enjoys proprietary rights under the depositary agreement that would be recognised in the insolvency of the depositary will depend on the terms of that agreement and Italian law. It is understood that the international clearers obtain the opinion of local counsel that their proprietary rights would survive the insolvency of a depositary. The proprietary link between

774 in section 3

775 on the likely assumption that the depositary’s insolvency would be governed by Italian law.

- 209 -
Euroclear and its participants is supported by legislation. Whether the assets would be safe from the general creditors of the sub-custodian in its insolvency will be determined by the terms of the sub-custodian agreement and Belgian law. Finally, the client will be able to recover its assets in the insolvency of the global custodian if, as a matter of English law, they are held for it on trust.

If any link in the chain fails, the client has only a personal claim and therefore bears the credit risk of the intermediary immediately above the failed link. Issuer (or market) risk is compounded by intermediary risk, and the value of the investment is reduced accordingly. The following sections will consider reasons why a link might fail in this way.

4. Civil law Jurisdictions

Global custody involves intermediation, or the separation of ownership from possession or control. Under English law, two legal relationships permit property to be held by one person yet owned by another: bailment and trust. Chapter 4 argued that bailment is of limited relevance in the modern securities markets, so that the concept of trusts is the main basis for intermediated proprietary rights under English law.

The function of the custody chain is to cross borders. The trust is an anglo-saxon concept, and not generally recognised in civil law jurisdictions. An alternative basis


777 on the assumption that its insolvency is governed by Belgian law. Where local custody is provided in Luxembourg through a branch, the position might differ as Luxembourg law applies the insolvency rules of the jurisdiction of incorporation.

778 see chapters 4 and 5.

779 subject to any contractual or general law duty on the custodian to make good any losses associated with sub-custodian insolvency; see chapter 8.

780 (because bailment necessarily implies tangible and allocated property)

781 "The civil code/common law division is now an uninteresting classification, except in relation to the trust." Philip Wood, Principles of International Insolvency, 1995, London, Sweet & Maxwell, p. 6. Professor Wood attributes the civil law rejection of trusts to the concept of false wealth. "The concept espoused in continental Europe from at least the time of Napoleon was that anybody who wanted a real right or rights in rem enforceable against everybody, including creditors, must not acquire it privately or secretly, but the right must be patent and published to the world. ...The principle root of this extraordinary doctrine that one person's
for conferring intermediated proprietary rights must therefore be identified in those jurisdictions. As noted above, the European international clearers have legislative support. Article 8 of the New York US uniform commercial code provides for proprietary rights in favour of purchasers of fungible securities held by financial intermediaries. In the absence of such legislation, how will civil law jurisdictions treat the custody assets? The position is complicated by the fact that the choice of law of the contracts governing the intermediary chain is not always the law of the jurisdiction of the intermediary. For example, the European clearers may require their local law to govern their depositary agreements. Also, some English global custodians require their sub-custody contracts to be governed by English law. Would an intermediated proprietary relationship purported to be created under such contracts be recognised in a jurisdiction having no such concept under its local law?

"In civil law jurisdictions... major problems arise because the trust concept is alien to their domestic law." An English law trust may be recognised if the jurisdiction is bound by the Hague Trusts Convention. "The Convention does not introduce the trust concept into the domestic law of countries lacking the concept ("non-trust countries"). ... The Convention does make non-trust countries, like trust countries, recognise trusts of property as a matter of private international law, (subject to significant safeguards)."

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782 Section 8-313 (1) (d)(ii) and (iii), and 8-313(2). Of course, New York is not a civil law jurisdiction


784 The UK, Italy, Luxembourg, United States, Canada, Australia and France have signed the treaty; the UK, Italy, the Netherlands, the provinces of Canada other than Ontario and Quebec and Australia have gone on to ratify it. Signing without more merely indicates an intention to implement in due course by legislation upon ratification.

785 Glasson, op. cit., c1.5 and 6

- 211 -
The Convention provides as follows:

"Such recognition shall imply, as a minimum, that the trust property constitutes a separate fund... In so far as the law applicable to a trust requires or provides, such recognition shall imply, in particular:
(a) that personal creditors of the trustee shall have no recourse against the trust assets;
(b) that the trust assets shall not form part of the trustee's estate upon his insolvency or bankruptcy;..."\(^{786}\)

However, certain provisions in the Convention may defeat the recognition of a trust arising under a contract governed by the law of a trust state, in the courts of a non-trust issuer jurisdiction. Article 13 may obviate the need for recognition where the underlying securities are issued in a non-trust state\(^{787}\). Arguably, article 15 may cut across recognition in the context of insolvency (and, incidentally, taking security)\(^{788}\).

Alternatively, the local courts may follow the approach of the Swiss Federal Court in *Harrison v Credit Suisse* securities\(^{789}\)\(^{790}\). Swiss law being the applicable law of a trust created by an American, it held that "it is necessary to examine to which legal institutions of Swiss law the legal relationship in dispute has the closest resemblance as far as its effects are concerned." The court found that the trust was really a mixed contract depending of the law of obligations, since it contained aspects of a contract of mandate,

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\(^{786}\) article 11.

\(^{787}\) "No state shall be bound to recognise a trust the significant elements of which, except for the choice of the applicable law, the place of administration and the habitual residence of the trustee, are more closely connected with States which do not have the institution of the trust or the category of trust involved." Article 13 does not form part of English law: the Recognition of Trusts Act 1987, which implemented the Convention, omits article 13.

\(^{788}\) "The Convention does not prevent the application of provisions of the law designated by the conflicts rules of the forum, in so far as these provisions cannot be derogated from by voluntary act, relating in particular to the following matters:
...d. the transfer of title to property and security interests in property;
...e. the protection of creditors in matters of insolvency."

Articles 15(1) (d) and (e) are excluded in implementing Dutch legislation so as to oust article 84 of Book 3 of the Dutch Civil Code, which does not recognise transfers to a person otherwise than as fully part of his patrimony.

\(^{789}\) [1993] 1 WLR 934; [1994] 1 WLR 452, CA.

\(^{790}\) AFT 96, 1970, II 79
of an agreement to make a fiduciary transfer of property, of a gift and of a contract for the benefit of a third party. 791 792

Where the Hague Convention and the principle in Harrison v Credit Suisse do not assist, the risk may remain that the custody assets are available to the creditors of an intermediary in its insolvency, unless the safekeeping arrangements clearly earmark the assets for the custodian’s clients. 793

5. Local restrictions not met

Another source of intermediary risk is failure to comply with issuer jurisdiction formalities. The use of street names (or informal sub-delegations of custody to local brokers to escape restrictions on foreign holdings) is widespread in some far East jurisdictions. 794

791 Hayton and Glasson, op. cit., C1.33.

792 For an example of the equivalent process under English conflicts law, see Macmillan v Bishopsgate (No 3) [1996] 3 All ER 747 at 769, 770: “Legal estates and equitable interests are, of course, concepts of English law which may not have their counterparts in the jurisprudence of other legal systems. Where, therefore, a question arises whether a transaction in England and governed by English law created a legal estate or an equitable interest in foreign property such as shares in a foreign corporation, then recourse must be had to the foreign law in order to ascertain, not how the interest resulting from the transaction would be characterised by that law, but what rights are conferred by that law on the owner of the interest. Once the nature of the interest is known, its characterisation as legal or equitable must be determined in accordance with English law. The essence of the distinction is that a legal estate binds all the world, whereas an equitable interest binds only the transferor and those deriving title under him with notice of the interest. In the case of a transaction in shares in a foreign corporation, the essential question is whether the interest of the transferee binds the corporation. If it does not, it cannot be what English law would recognise as a legal interest."

793 “In the pure non-trust countries in the classical mould, …the possessor of goods…held under custodianship is the real owner, unless the goods are segregated and marked as belonging to another. The registered holder of registered securities is deemed the owner even though he is a custodian, clearing-house or nominee. The possessor of bearer negotiable instruments is the owner unless they are segregated and marked in the same way as goods belonging to another.” Philip Wood, Principles of International Insolvency, 1995, London, Sweet & Maxwell, p. 39. “In order to avoid this result [of custody securities going to the creditors of the insolvent custodian], bearer securities must be bundled together and marked with the true owner’s name and registered securities must be registered in the books of the issuer in the name of the true owner (not the custodian) or, sometimes, registered in the name of the custodian with an indication that they belong to third parties - many registration systems do not permit notice of the owners to appear on the register, mainly to avoid confusion as to who to pay.” (pp. 40, 41)

794 Another example is investment in Russia. Although a civil law jurisdiction, Russian law has a limited statutory concept of trusts. The beneficial ownership of shares by a person other than the registered holder is recognised, provided that a note of the beneficial holding is entered on the register of the issuer or the registered holder is a financial intermediary. In order to benefit from a double taxation treaty between the Russian Federation and Cyprus, it is customary for much western investment in Russian shares to be held through a Cyprus nominee. The nominee agrees to hold the shares for investors under the terms of a Cyprus trust, and opinion is taken from
The historic and legitimate function of global custody is to address the inefficiencies and risks involved in cross-border investment. However, where the custodian goes further and seeks to assist the client in defeating the policy requirements of the issuer's jurisdiction⁷⁹⁵, care should be taken. The risk is that, by seeking to make the client's position invisible in the issuer's jurisdiction, it is unenforceable there. The rules of private international law may render local enforceability indispensable.

6. Commingling

Custody securities are generally commingled in the hands of each intermediary in the custody chain. In other words, each intermediary will hold any particular custody securities in a mixed account together with other like securities held for other beneficial owners. As property may be loosely described as a legal relationship between persons and assets, the general rule is that a proprietary right can only arise in relation to identifiable assets. The difficulty for the investor is that it cannot identify which of the securities within the pooled account belong to it. Chapter 5 considered this problem ("the Allocation Problem") under English law. It suggested that the answer is the concept of co-ownership, whereby all investors having interests in the pool together co-own all the securities in the pool. Such co-ownership may be implied under English law, but the position is uncertain, and express co-ownership provision is recommended in the custody documentation⁷⁹⁶. In Belgium and Luxembourg, it was felt necessary to pass legislation confirming proprietary rights in commingled (or fungible) accounts; a similar result is provided by Article 8 of the New York Uniform Commercial Code⁷⁹⁷. The existence of this legislation suggests that the position at general law is uncertain.⁷⁹⁸ Some doubt must therefore arise where custody securities are commingled in jurisdictions having no equivalent legislation. It would be prudent for the global custodian or its clients to obtain

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⁷⁹⁵ such as taxation, or restrictions on foreign ownership of securities.

⁷⁹⁶ see chapter 5

⁷⁹⁷ See section 3 above.

⁷⁹⁸ It is uncertain in common law as well as in civil law.
the opinion of local counsel that commingled securities will be safe in the insolvency of the local sub-custodian or other intermediary.

7. **Shortfall and Contractual Settlement**

Even if a trust or similar arrangement is recognised in the insolvency of the intermediary, the client will still suffer loss if all its securities are not there. "Shortfalls in custodial holdings may develop for a number of reasons, including the failure of trades to settle as anticipated, poor accounting controls, or intentional fraud. The shortfalls may be temporary or long-standing. Allocation of the risk of loss from a shortfall will vary depending on the circumstances under which the shortfall arose. Of course, if the custodian is solvent, no real problems arise; it may either replace the missing securities, or pay damages, or both. However, if the custodian is insolvent, or the shortfall arises from fraud or insolvency on the part of a sub-custodian or CSD, the investor's risk of loss may be severe. In a cross-border context, the involvement of multiple legal jurisdictions and multiple settlement intermediaries increases the importance of custody risks and greatly complicates their analysis."

A special risk associated with commingled accounts is that shortfalls attributable to the business of one client may be borne by other clients sharing the account. Where segregated accounts are not offered, therefore, prudent clients may wish to enquire whether the custodian engages in practices which heighten the risk of shortfall. An obvious example of such a practice is the contractual settlement of securities. Contractual settlement is a service offered by some global custodians in relation to cash or (more rarely) securities. It is agreed that, where monies or securities are due to be received under a trade, those assets will be credited to the client's account on the date agreed for settlement with the counterparty, whether or not they are actually received on that date by the custodian. The custodian reserves the right to reverse the credit entry if the assets do not arrive within a reasonable period. Contractual settlement amounts to lending of cash and/or securities. Where contractual settlement of securities is offered in connection with commingled securities accounts, clear dangers arise. If 100 bonds are contractually settled, the client is free to sell them to a third party. If the original trade

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800 Custodians only offer contractual settlement in markets where they are confident of settlement.

801 (raising issues of authority to lend and borrow such assets, as well as taxation issues).
fails, the custodian cannot reverse the credit entry without causing a shortfall. Further, as the contractual settlement of securities amounts to securities lending, the question arises, from whom is the client borrowing? It will only be borrowing from the custodian if the custodian transfers new securities into the commingled account to support the transaction. If the custodian does not do this, the client is borrowing securities from the other clients of the custodian, without their consent or knowledge. Under English law, such arrangements may involve the custodian in liability for theft. In the custodian's insolvency, the consequent shortfall would be handled in accordance with the equitable tracing rules.

8. Liens

A further risk to the custody assets is the possibility of liens or other security interests in favour of intermediaries in the global custody chain, such as sub-custodians and settlement systems. For example, if a global custodian becomes insolvent, a sub-custodian may enforce a lien over the client assets it holds for the global custodian in respect of unpaid fees. Where fungible custody is offered, one client's assets may in effect be charged to secure exposures referable to the business of another client. The SFA rulebook restricts the ability of authorised firms to permit custodial liens to be taken over client assets.

9. Liquidator's Costs

The case of Berkeley Applegate (Investment Consultants) Ltd established the principle that, where the assets of the insolvent company are insufficient to meet the liquidator's costs in administering property held on trust by the company for its clients, the court has discretion to award those costs out of the trust assets.

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802 (as in prime brokerage.)

803 Rules 4.6.d and 4.7.d. The European clearers exempt participant client accounts from their security interests for this reason.

804 [1988] 3 All ER 71

805 at 76, 82.

"The authorities establish, in my judgment, a general principle that where a person seeks to enforce a claim to an equitable interest in property, the court has a discretion to require as a condition of giving effect to that equitable interest that an allowance be made for costs incurred and for skill and labour expended in connection with the administration of the property. It is a discretion which will be sparingly exercised..." (at 83).
This principle may pose a threat to the assets of custody clients where the custodian does not have substantial assets of its own, and where adequate records of the custody have not been kept, so that significant work is required to clarify the entitlements of clients.

10. Conflict of Laws

Cross-border insolvency raises complex legal issues. However, not all of them are directly relevant to custody. Liquidation is the legal procedure for the collection, administration and distribution of the assets of the insolvent. In theory, the insolvent liquidation of the custodian should not affect custody assets, as these are the assets, not of the insolvent, but of its clients. But, as indicated above, the courts of the different jurisdictions involved may take a different approach to the recognition of trusts and the allocation of shortfalls. The manner in which these differences will be handled is inherently unpredictable, partly because the English private international law of insolvency is uncertain, and partly because the international position is very far from being harmonised. The following are a few very general comments on the subject.

"Accordingly, I propose to declare that the liquidator is entitled to be paid his proper expenses and remuneration out of the trust assets if the assets of the company are insufficient." (at 85).

This principle was applied in the liquidation of T C Coombes.

Several important questions may arise when insolvency is attended by the presence of foreign elements. These are, first, whether the courts of England and Wales may competently exercise jurisdiction over the debtor, and if so, what rules of choice of law are to be applied in the circumstances. Secondly, assuming that the debtor is amenable to the bankruptcy jurisdiction of the English courts, whether the courts of one or more foreign countries may simultaneously have competence to open proceedings, and if so with what consequences. Thirdly, in view of the possibility that a debtor's assets, and also his liabilities, may be connected with or governed by the laws of a variety of different countries, whether the orders and decisions of a court in one jurisdiction may be effective in relation to property, and also persons, not currently within the territorial jurisdiction of that court. Ian Fletcher, The Law of Insolvency, 2ed, 1996, London, Sweet & Maxwell, p. 682.

As indicated in section [1], these comments relate to custody securities and not custody cash.

"The relevant statutory provisions have been developed piecemeal over an extended stretch of time, and many of them still belong essentially to the nineteenth century in their substance, attitude and outlook. Hence, they belong also to an epoch when the theory and practice of private international law rested upon principles and doctrine which have undergone wholesale revision, often of a revolutionary nature, during the 20th century." Fletcher, The Law of Insolvency, p. 687.

Lack of progress in harmonisation is perhaps due to the profound political and social differences that underlie the different provisions of nations' insolvency laws.

However, within Europe some progress is being made towards harmonisation with the Bankruptcy Convention and the Winding Up Directive (discussed in section d below). See also the Istanbul Convention of the Council of Europe which seeks to achieve co-operation in cross-border insolvencies.

- 217 -
a. general principles

i. jurisdiction

- universality and plurality In the theory of the private international law of insolvency, two conflicting sets of principles determine the varying approach of different courts to jurisdiction. Under the principles of universality and unity, one set of insolvency proceedings in the jurisdiction of the insolvent governs the insolvent's assets worldwide. Under the principles of plurality and territoriality, each forum governs assets in its jurisdiction. In practice a compromise between the two is usually reached.

Global custody is international in two senses. Firstly, the arrangements involve intermediaries in different jurisdictions. Secondly, the arrangements relate to assets in different jurisdictions. While, generally, local assets will be held by local intermediaries there will be circumstances where an intermediary holds international assets. The question, therefore, arises whether the foreign assets of an insolvent English custodian will be subject to English or to foreign insolvency proceedings. Under the principles of unity and universality, the English courts would prevail; under the principles of plurality and territoriality, the foreign courts would deal with the assets.

In principle, English insolvency relates to assets wherever located. However, this universal approach may in practice be limited by pragmatic difficulties of enforcement against foreign assets in circumstances where local creditors may assert claims against those assets under local law.

810 (so that, for example, French bonds are held by a French sub-custodian)

811 For example, as between the global custodian and a French sub-custodian, the asset of the global custodian may be a proprietary right arising under French law, i.e. a French asset, enforceable and therefore located (for conflicts purposes) in France. On this basis, with a mixed portfolio, the assets held by the global custodian for its client may be legally located across all of the jurisdiction in which the client has invested.

812 Section 144 of the Insolvency Act 1986.

813 “It is one thing for a legal system unilaterally to advance the claim of universal effectiveness for the insolvency orders pronounced by its own courts; it is quite another thing for such judgments automatically to command that effectiveness internationally.” Fletcher, The Law of Insolvency, p. 688. Local assets are only accessible
Moreover, while the English courts may assume jurisdiction over foreign assets under the universal approach, they do not necessarily limit their jurisdiction over English assets of foreign companies in accordance with the same universal approach.\textsuperscript{814} Because enforcement is more important than theory, in practice it would be prudent to assume that, in a custodian’s insolvency, assets will be dealt with in accordance with the law of the jurisdiction in which the assets are located. The legal location of custody securities is often a nice question, as discussed in chapter 7.

**Jurisdiction of the English courts**

The English courts’ jurisdiction to wind up companies depends on whether they are English registered and, if they are not, on whether there is a sufficient connection with the jurisdiction.

**English registered companies**

The English courts have discretionary jurisdiction to wind up any company registered in England\textsuperscript{815}.

**Unregistered company**

(i.e. a company not registered under the Companies Act\textsuperscript{816}. The English courts have jurisdiction to wind up an unregistered company if, broadly, the company has ceased business, is

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\textsuperscript{814} i.e. the English courts may assume jurisdiction over the liquidation of a foreign company in certain circumstances (see below in this section). Where it does so, its jurisdiction is not limited to an English branch of the company or its English assets, but in principle may extend to the whole of the company (although, if there is also a home-state proceeding an English court is likely to order that the English liquidation be ancillary i.e. territorial). Contrast this "universal approach" to the "ring fence" approach of Germany (local proceedings for a foreign company confined to local branch and local assets) and the "no local proceedings" approach of Belgium (no local proceedings for a foreign company, but recognition of home state liquidation).

Moreover, "[T]here is no rule of English law whereby the proprietary effects of a foreign liquidation are recognised as extending beyond the territorial limits of the jurisdiction in which the foreign liquidation has taken place." Fletcher, op. cit. p. 763.

\textsuperscript{815} Insolvency Act 1986 section 117.

\textsuperscript{816} Insolvency Act 1986 section 220. "Company" for this purpose is widely defined.
unable to pay its debts or if it is just and equitable to do so. Case law\textsuperscript{17} indicates that in practice the English courts will assume jurisdiction to wind up a foreign company if either the company at the time a petition is presented has assets in England or at any time has carried on business in England either directly or through an agent and in both cases that there is a reasonable possibility of benefit accruing to creditors in making the winding up order.\textsuperscript{18}

\textit{Civil Jurisdiction and Judgments Act 1982} This Act, which implements the Brussels and Lugano Conventions\textsuperscript{19}, does not apply in respect of the winding-up of insolvent companies.\textsuperscript{20}

\textit{forum non conveniens} Jurisdiction may be declined in order to prevent injustice where another forum of competent jurisdiction is more suitable, as discussed in chapter 6 section B.3.

\textbf{ii. Proper Law}

As a general rule, insolvency is governed by the law of the jurisdiction in which it is conducted (\textit{lex fori} or \textit{lex concursus}) (although there are important exceptions to this\textsuperscript{21}).


\textsuperscript{18} (In practice it may also be necessary to show that there are no home state proceedings or that the home state liquidator agrees to the institution of English liquidator, or alternatively that the foreign proceedings are prejudicial to English creditors.)

\textsuperscript{19} (discussed above in chapter 6 section B.1)

\textsuperscript{20} For the Act to be disapplied on the basis of proceedings concerning winding up it is necessary that they derive directly from the winding up and be closely connected with the winding up proceedings: Courdian v Nadler [1979] ECR 733.

\textsuperscript{21} For example, where the Luxembourg branch of a foreign entity is wound up in Luxembourg, the Luxembourg courts will apply the law of the jurisdiction of incorporation.
Under section 426 of the Insolvency Act 1986, the English courts may apply foreign law if so requested by certain (mainly) Commonwealth courts. 822

iii. concurrent insolvency proceedings

Clearly, if insolvency proceedings are also being taken out in other jurisdictions, some form of cooperation would have to be achieved, by recognition or otherwise. 823 "Therefore, whenever the assets of an insolvent debtor are dispersed between two or more jurisdictions the effectiveness and efficiency of any insolvency proceedings centred in one country will be dependent upon the degree of recognition and cooperation accorded by the laws of the other jurisdictions involved." 824

b. insolvency risk

822 "The courts having jurisdiction in relation to insolvency law in any part of the United Kingdom shall assist the courts having corresponding jurisdiction in any other part of the United Kingdom or any relevant authority or territory. The relevant designated territories are: Channel Islands, Isle of Mann, Anguilla, Australia, Bahamas, Bermuda, Botswana, Canada, Cayman Islands, Falkland Islands, Gibraltar, Hong Kong, Republic of Ireland, Montserrat, New Zealand, St Helena, Turks and Caicos Islands, Tuvalu, British Virgin Islands. The court may apply the insolvency law "applicable to either court in relation to comparable matters falling within its jurisdiction" but the court "shall have regard in particular to the rules of private International law." In other words, the courts must have regard to the English conflicts rules applicable to bankruptcy and not slavishly apply the laws of the foreign bankruptcy forum..." Wood, Principles of International Insolvency, pp. 255, 256.

"For example, the provisions in section 426(4) and (5) may enable our courts to deal in an appropriate manner with property claimed by the foreign trustee or liquidator, where it is alleged that the property was the subject of a voidable transaction entered into by the debtor at some previous time. If, on the basis of applying English rules of private international law, the English court concludes that the validity of the transaction is to be determined according to the law of some other country, that process may be carried to its logical conclusions to enable the court to determine the destination of the property currently located within its jurisdiction." Fletcher, p. 787.

"It is at once apparent that section 426(4) is narrower than the common law in two important regards. The section applies only with reference to courts in the United Kingdom, the Channel Islands, the Isle of Man and the 17 jurisdictions thus far designated, whereas at common law the English court may recognise the authority of any foreign trustee, assignee, liquidator, curator, administrator etc. But, of course, section 426(4) does not prevent the court giving assistance to a French, Danish or American trustee. In addition, section 426(4) becomes relevant only following a request from a foreign court, not simply at the instance of a foreign trustee or liquidator. Hence if a foreign liquidator's authority to bring proceedings to enforce the corporation's rights is recognised at common law there will be no need for reference to the statutory procedure." Philip Smart, Cross-Border Insolvency, 1991, Butterworths, London, pp. 259, 260.

823 "...most states will allow concurrent proceedings to be opened, whether an ancillary proceeding or a full bankruptcy... the effect of the local proceedings is to allow the local jurisdiction to give effect to its own bankruptcy." Wood, Principles of International Insolvency, p. 242.

824 Fletcher, p. 767.
Insolvency risk, or the risk that a local jurisdiction will not recognise the custody trust in respect of local custody assets (so that such assets are available to creditors of the custodian) is discussed above. Where an English custodian becomes insolvent, as a matter of English law the custody assets will be impressed with the custody trust wherever those assets are located. However, in practice local courts may take a territorial approach, and hence the need to ensure that local assets (such as claims against sub-custodians and depositaries) are legally robust as a matter of local law, and that local law will not make the custody assets available to creditors (or to rival insolvency officials where multiple insolvency proceedings are taken out).

c. shortfall risk

Where there is a shortfall in the pooled client account of an insolvent custodian, the question arises what law will govern the manner in which that shortfall is borne by the respective clients. If the custodial relationship is governed by English law and the assets are governed by foreign law, it may be argued that the English tracing rules would govern the allocation of the shortfall, as part of the law of trusts that governs the custodial relationship wherever the custody assets are located. Another possibility is that the local jurisdiction treats the allocation of shortfalls as a procedural matter, and therefore applies its law as the law of the forum. In any case, the question only arises where there is a conflict between English and foreign law; such conflicts may be less unlikely as many jurisdictions "pro rate" losses among all clients, which appears to be the current approach of the English courts in active commingled accounts.

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825 This is because equity acts in personam; the jurisprudential basis of the trust is the relationship between trustee and beneficiary, so that the lex situs rule does not apply. Accordingly, the trust created over the assets of a company by a winding up order extend for foreign assets: see Fletcher, pp. 751, 752.

826 While the making of an English winding up order stays all actions by unsecured creditors against the insolvent company or its assets under section 130(2) of the Insolvency Act, this would not bind foreign creditors outside the jurisdiction.

827 (e.g. the assets consist of debts, shares or other choses in action whose governing law is foreign)

828 See Barlow Clowes International v Vaughan [1992] 4 All ER 22. However, the pro ration adopted in this case may not be the invariable practice.
Two proposed European measures may be of relevance to insolvency conflict of laws for global custodians. The aim of both the Bankruptcy Convention and Winding Up Directive is to harmonise the rules relating to insolvency jurisdiction and choice of law within the EC.

i. the Bankruptcy Convention

The Convention applies to all collective insolvency procedures (i.e. liquidation and administration but not receivership). It provides that the courts of the state of the insolvent’s “centre of main interests” (“home state”) has jurisdiction to open insolvency proceedings. The place of the company’s registered office is rebuttably presumed to be its home state. Secondary winding up proceedings are permitted in other member states only if the insolvent has a local establishment; any such secondary proceedings must be “ring fenced” to that local establishment and limited to assets in the second member state. These jurisdiction provisions are supported by recognition provisions.

The law of the state in which proceedings are taken out governs them, and determine among other things which assets are available to creditors.

However, the Convention may be of limited relevance to custody insolvency, for the following reasons. It does not apply (broadly) to

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829 Articles 1(1) and 2(a) and Annex A.
830 Article 3(1).
831 Articles 3(2) and 3(3). “Establishment” is defined as “any place of operations where the debtor carries out a non-transitory economic activity with human means and goods.” (Article 2(g)).
832 Article 27.
833 Chapter II.
834 Articles 4(1) and 28.
835 Article 4(2)(b). This law also determines who bears the costs of liquidation (Article 4(2)(1)); this can be relevant to custody clients in view of the rule in Berkeley Applegate; see section [9] above.
banks or investment firms providing custody.\textsuperscript{536} This may exclude most custodians, but not necessarily the affiliate nominees who may hold client assets.

There is a carve out for third party proprietary rights (or rights in rem) at least in respect of assets within the EC.\textsuperscript{837} The natural reading of this provision is that the validity of the custody trust will be determined under normal conflicts rules\textsuperscript{838}. (The same is true of the validity of security interests).

Custody assets not situated within a member state, the position seems to be governed by the general provision\textsuperscript{839} that the law of the state in which proceedings are taken out governs the availability of assets to the creditors of the insolvent (although this is limited to home state proceedings\textsuperscript{840}).

\textsuperscript{536} "This Convention shall not apply to insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings which provide services involving the holding of funds or securities for third parties, or to collective investment undertakings." Article 1(2).

\textsuperscript{837} Article 5 provides as follows:

\begin{enumerate}
\item "The opening of insolvency proceedings shall not affect the rights in rem of creditors or third parties in respect of tangible or intangible, movable or immovable assets belonging to the debtor which are situated within the territory of another Contracting State at the time of the opening of proceedings."
\item "The rights referred to in paragraph 1 shall in particular mean:
\begin{enumerate}
\item the right to dispose of assets or have them disposed of and to obtain satisfaction from the proceeds of or income from those assets, in particular by virtue of a lien or a mortgage;
\item a right in rem to the beneficial use of assets."
\end{enumerate}
\end{enumerate}

The wording of article 5(2)(d) is curious, but should be interpreted to include interests under trusts.

\textsuperscript{838} (although it might be argued that the Convention does not indicate which law will determine whether clients' rights are rights in rem or not, posing the threat that the foreign liquidator will not be obliged to recognise the English law trust).

\textsuperscript{839} (in article 4(2)(b))

\textsuperscript{840} Article 27. In relation to secondary proceedings, non-EC assets are outside the scope of the Convention.
There is a further carve out for payment systems and financial markets within the EC.\textsuperscript{841}

\textit{ii. The Winding Up Directive}

The Winding Up Directive applies to credit institutions, and is closely modelled on the Bankruptcy Convention. However it is somewhat simpler in that no secondary proceedings are permitted. It is still in draft form.

\textit{iii. timetable}

The initiative for the Convention began in the 1960s but encountered long delays. The unsatisfactory conflicts position following the collapse of BCCI in 1991 led to progress being made in the mid-1990s. The text was finalised in 1995 but Britain missed the May 1996 signature deadline because of the beef crisis. It will come into force 6 months after the last signature. The ratification process will take longer. The draft of the Winding Up Directive is well advanced and the Directive will probably be made in 1997. Implementation may take a further 3 years, so that both measures may be in force by the new millennium.

It is proposed that separate measures will cover the insolvency of EC investment firms\textsuperscript{842}, but these have not yet been published.

\begin{footnotesize}
\textsuperscript{841} Article 9 provides as follows:\textsuperscript{-}

(1) ...the effects of insolvency proceedings on the rights and obligations of the parties to a payment or settlement system or to a financial market shall be governed solely by the law of the Contracting State applicable to that system or market.

(2) Paragraph 1 shall not preclude any action for voidness, voidability or unenforceability which may be taken to set aside payments or transactions under the law applicable to the relevant payment system or financial market.\textsuperscript{”}

\textsuperscript{842} (and insurance companies, which are also not covered by either the Bankruptcy Convention or the Winding Up Directive)
\end{footnotesize}
11. Insolvency Risk in Practice

Cross border insolvency is problematic, for historical\textsuperscript{843} and political\textsuperscript{844} reasons. Much theoretical material has been written. However, in practice a pragmatic approach is called for.\textsuperscript{845} If sub-custodial arrangements are supported by reasonably clean legal opinions, it may be unnecessary to enquire further in practice.

E. Conclusions

Conflicts of law will never be certain, and the doubts associated with the proprietary aspects of global custody are inexhaustible. This is particularly true where custody securities are used as collateral. However legal uncertainty in commercial affairs is not new. Commercial law has always followed practice, and legal consensus may eventually follow the increasing harmonisation of practice.\textsuperscript{846}

In the meantime, risk can be managed by focus on operation controls (in particular the speed with which collateral can be realised). Beyond that, it may properly be borne. Investment business is risk business, and a measure of legal risk may be tolerated, provided it is understood.

\textsuperscript{843} Firstly, civil law and (to a lesser extent) common law is still dominated by Roman law, and the operation of insolvency law is based on the old Justinian distinction between rights of persons and rights of things, which is probably obsolete in relation to an electronic product such as global custody. Secondly, law follows political regimes, and England has not been invaded since 1066; the trust (on which custody rests) has developed in anglo saxon jurisdictions, but is unknown in continental Europe.

\textsuperscript{844} Insolvency law, and in particular jurisdictions' differing for ranking creditors, reflect differing political priorities (e.g. whether employees should be postponed to secured bank creditors).

\textsuperscript{845} "The rules of cross-border insolvency tend to establish boundaries rather than lay down rigid and detailed procedures to be applied in all cases, and within those boundaries the practitioner is free to work towards the most advantageous solution for his or her client. In addition, the need for flexibility is underlined by the broad range of issues which fall to be determined by the English court in the exercise of its discretion." Philip Smart, Cross-Border Insolvency, p. vii.

\textsuperscript{846} Offered by the growing use of central depositaries and initiatives such as G30.
Chapter 8. The Custodian’s Duties

"To describe some one as a fiduciary, without more, is meaningless."  

Operational failures in the holding and administration of a portfolio of securities can cause significant losses to clients. Where such losses occur, global custodians may choose to make them good irrespective of legal liability, in order to preserve the client relationship. However, losses may be so great that liability would have severe consequences for the global custodian. Very broadly speaking, the custodian will be liable where client losses are attributable to its breach of duty. Duty is the measure of potential liability. Control of levels of legal duty is therefore an essential part of risk management for the global custodian.

The chief method of controlling levels of duty is the use of duty defining and limitation of liability clauses in the global custody contract; as indicated below, these are highly effective in modifying the level of duty implied by general law. Indeed, such clauses are arguably the real reason for the global custodian to put a global custody contract in place. These contractual techniques are discussed in section B below. Section A provides the context of duty at general law.

A. General Law

1. Is the Custodian a Fiduciary?

The interrelation of fiduciary duties and financial arrangements has been much discussed in recent years. While fiduciary duty is a very uncertain area of law, it is possible

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847 This chapter focuses on fiduciary duty and liability. For liability for breach of contract or tortious liability (such as negligence), the general principles of the law of contract and tort apply to the global custodian. These are touched on only very briefly in section F.

848 Re Goldcorp Exchange Ltd (in receivership) [1994] 2 All ER 806, per Lord Mustill at 821.

849 For a fuller discussion, see section A below.

850 Conversely, the practice of offering undocumented global custodian services exposes the global custodian to the risk of unmodified general law duties, implying commercially unacceptable levels of potential liability.

851 Debate has been stimulated by a May 1992 Law Commission Consultative Paper, Fiduciary Duties and Regulatory Rules and a subsequent Report having the same title and published in December 1995 (Cm 3049).
to make the following generalisations. Fiduciary relationships are relationships of special
trust: "The 'fiduciary' standard for its part enjoins one party to act in the interests of
another - to act selflessly and with undivided loyalty. " The significance of fiduciary
status here is that fiduciaries owe special implied duties to their beneficiaries.
Fiduciary duties are summarised in four basic rules:

- the no conflict rule,
- the no profit rule,
- the undivided loyalty rule, and
- the duty of confidentiality.

852 "This area of law is highly complex, poorly delimited, and in a state of flux. This is not necessarily a criticism
and courts and commentators have supported the current state of the subject. Some have said that attempts at
definition are unwise or inappropriate, while others have pointed to the open-ended and prophylactic nature of
the fiduciary concept, which necessarily defies definition. It is unclear at the present time whether the term
"fiduciary" has generally been descriptive, providing a veil behind which individual rules and principles have
been developed, or whether the case law evidences the steady development of the fiduciary concept towards an
all-embracing principle." Law Commission Consultation Paper, May 1992, pp 26, 27. See also P.D. Finn,
question I wish to raise is, simply, whether the fiduciary principle is no more than a sub-species in the law, with
its organizing principle lying beyond it, not in it."

853 "Broadly speaking, a fiduciary relationship is one in which a person undertakes to act on behalf of or for the
benefit of another, often as an intermediary with a discretion or power which affects the interests of the other
who depends on the fiduciary for information and advice. ... in determining whether a relationship was fiduciary,
and if so, the extent of the fiduciary duties, a court would look at the substance of a relationship and not merely


855 More generally, in certain common law jurisdictions including England, "...to designate someone a fiduciary
is to expose that person to the full rigour of equity both in method [for example, in reversal of the onus of
proof, in presumptions of wrongdoing and in disregard of notions such as causation, foreseeability and
remoteness] and in remedy [from avoidance through damages and the account of profits to the constructive trust]
..." P.D. Finn, The Fiduciary Principle, p. 2.

856 "The exact scope of the fiduciary's obligations and the consequences of breach vary according to the particular
circumstances but the duties may conveniently be summarised in the following basic rules:

(i) the "no conflict" rule A fiduciary must not place himself in a position where his own interest
conflicts with that of his customer, the beneficiary. There must be a "real sensible possibility of
conflict";

(ii) the "no profit" rule A fiduciary must not profit from his position at the expense of his customer,
the beneficiary;

(iii) the "undivided loyalty rule" A fiduciary owes undivided loyalty to his customer, the beneficiary,
not to place himself in a position where his duty towards one customer conflicts with a duty that
he owes to another customer. A consequence of this is that a fiduciary must make available to a
Beyond these rules (which are derived from the general duty to act in the interests of the beneficiary) fiduciary status does not prescribe positive duties. Thus, the particular services that a custodian must render are determined by its agreement with its client, and not by implied fiduciary status. Fiduciary status does not determine the content of the relationship between the parties; rather it is (in essence) merely a judicial remedy for want of loyalty where loyalty is owed.857

The argument that a global custodian is not a fiduciary is considered to be untenable. Because of its safekeeping role, the custodian is either a trustee or a bailee.858 A trustee is always a fiduciary.859 Whether or not a bailee is a fiduciary will depend on all the circumstances and the terms of the bailment.860 However, because the custodian role actively combines safekeeping with administration and settlement on behalf of the client, it would be prudent to assume that the global custodian is a fiduciary.861

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857 See Finn, The Fiduciary Principle, p. 28.
858 See chapter 3. As discussed in that chapter, trustee status is the more likely characterisation of global custodians in respect of most of their current business.
859 "...it is possible to divide fiduciaries into two categories, status-based fiduciaries and fact-based fiduciaries. ...[The latter] include people who, by virtue of their involvement in certain relationships are considered, without further inquiry, to be fiduciaries. Such relationships include those between trustee-beneficiary, solicitor-client, agent-principal, director-company, and partner-partner." Law Commission Consultation paper, pp. 27, 28.
860 Re: Andrabell Ltd (in liquidation), Airborne Accessories Ltd [1984] 3 All ER 407 per Peter Gibson J.
861 "a "fiduciary relation" exists ... wherever the plaintiff entrusts to the defendant property ... and relays on the defendant to deal with such property for the benefit of the plaintiff or for purposes authorised by him, and not otherwise ...". Reading v Attorney General [1949] 2 K.B. 232.

See also In re Brooke Bond & Co. Ltd.’s Trust Deed [1962] 1 Ch 357, in which a custodian trustee is held to be subject to the fiduciary “no profit” rule.

See also Finn, The Fiduciary Principle, p. 35: “In many instances property is a subject of a legal relationship with one party having custodial or other rights in or to that property. To the extent that party has limited or indeed no rights to its beneficial use and enjoyment, that person’s position is incipiently fiduciary.”

In a writ issued on 5 June 1992 by MGN Pension Trustees Limited against Bank of America National Trust and Savings Association and Credit Suisse, the trustees of the Maxwell pension fund sued Bank of America as custodians of the pension fund assets, asserting that they should not have settled instructions from the managers
2. Bailee

The traditional legal characterisation of the custodian of securities is as bailee of the client. Chapter 4 argued that this characterisation may no longer appropriate. However, there may still be cases where the global custodian is a bailee. What then are a custodial bailee's duties at common law?

"A bailee for reward must take reasonable care of any articles in his possession: B.R.S. Ltd. v Arthur V. Crutchley Ltd (1968). The degree of precaution must be gauged according to the value of the goods, their disposability and portability, their vulnerability to theft, and to such other factors as the overall risk to them and the prevalence of crime in the vicinity. In the case of a bank the duty is to take such care as a reasonably prudent banker would take, in like circumstances, of the property of his clients". 864

From the discussion of trustee's duties that follows, it will appear that the recharacterisation of the global custodian as trustee does not significantly alter the level of its duties, for the following reason. Although the level of duty implied at common law for a trustee is higher than that so implied for a bailee, the shared fiduciary status of both trustees and bailees imposes the same restrictions on their ability contractually to limit their duties. Therefore, assuming that the customary limitation clauses are included in the global custody agreement, the same core level of inexcludable fiduciary duty will be owed by the global custodian, whether as bailee or as trustee.

3. Trustee

whereby the pension fund assets were lost. The writ asserted that Bank of America was a fiduciary: "In the premises, and by reason of the [custody] Agreement and by reason of its position as custodian of assets of the [pension fund], BA owed fiduciary duties to the Trustee and the [pension fund]." (p. 25).

862 In view of the electronic and fungible basis of modern custodial arrangements, the global custodian will in general hold securities as trustee.

863 (where documents of title are physically held by custodian for a client and segregated from instruments held for other clients, so that in specie redelivery is possible)

864 Palmer, Liability of Bankers as Custodians of Clients Property (1979), pp. 9, 10.
Trusteeship is "the most intense form of fiduciary relationship"\textsuperscript{865}. The level of implied duty imposed on a trustee is higher than that imposed on a bailee. The test for non-professional trustees is the level of care with which an ordinary prudent man of business would conduct his own affairs\textsuperscript{866}. However, a higher duty of care is expected from professional trustees (who advertise themselves as such). The rule in \textit{Re Waterman's Will Trusts}\textsuperscript{867} provides that the trustee holding itself out as possessing special skills and which is paid for its services must observe a higher standard of diligence and knowledge than an unpaid trustee, and will be expected to exercise a greater degree of care. This rule was expanded in the case of \textit{Bartlett v. Barclays Bank (No 1)}\textsuperscript{868} in which Brightman set the test as "the special skill and care which [the professional trustee] professes to have".\textsuperscript{869}

\section*{B. Contract}

The global custody contract should contain an exhaustive list of the services that will be provided, and as much operational detail as possible should be included.\textsuperscript{870} These duty defining clauses delimit the extent of the contractual duties of the global custodian. Perhaps even more importantly, limitation clauses delimit the liability of the global custodian who fails to perform its contractual or fiduciary duties.\textsuperscript{871} The case law

\begin{footnotesize}
\begin{itemize}
    \item \textsuperscript{865} Law Commission Consultation Paper, p. 84.
    \item \textsuperscript{866} \textit{Speight v Gaunt} (1883) 9 App. Cas. 1, per Lord Blackburn: "...as a general rule a trustee sufficiently discharges his duty if he takes in the managing of trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own." (at 19)
    \item \textsuperscript{867} [1952] 2 All ER 1054, per Harman J: "I do not forget that a professional trustee is expected to exercise a higher standard of diligence and knowledge than an unpaid trustee and that a bank which advertises itself largely in the public press as taking charge of administrations is under a special duty." at 1055
    \item \textsuperscript{868} [1980] Ch 515
    \item \textsuperscript{869} The ordinary trustee is required "to be prudent and exercise the degree of care he would in conducting his own affairs but mindful, when making investment decisions, that he is dealing with another's property" while "a professional person, a trust corporation..., held out as an expert, will be expected to display the degree of skill and care and diligence such an expert would have." Per Lord Nicholls (1995) 9 TLI 71, 73 - 76.
    \item \textsuperscript{870} It is customary to specify detailed provisions in a service annex, which is incorporated by reference in the global custody agreement.
    \item \textsuperscript{871} While duty defining clauses specify what the client can expect, limitation clauses specify the client's recourse if it is disappointed.
\end{itemize}
\end{footnotesize}
relating to limitation clauses\textsuperscript{872} indicates that they are extremely effective, although limitation clauses are subject to certain limits.\textsuperscript{873}

1. Case law

Contract is generally effective in modifying fiduciary duty, as well as imposing particular restrictions on liability.

a. contract and fiduciary duty

The position of the global custodian seeking to rely on contractual limitation provisions is enormously strengthened by the case of Kelly v. Cooper Associates\textsuperscript{874}, in which it was stated\textsuperscript{875} that a fiduciary relationship arising in the context of a contractual deal should not change the nature of the deal. Lord Browne-Wilkinson quoted an earlier case\textsuperscript{876} as follows:

"That contractual and fiduciary relationships may co-exist between the same parties has never been doubted. Indeed, the existence of a basic contractual relationship has in many situations provided a foundation for the erection of a fiduciary relationship. In these situations, it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to them. The fiduciary relationship cannot be superimposed upon the contract in such...

\textsuperscript{872} It is understood that the regulatory authorities in Dublin and Luxembourg are cautious in their approach to limitation clauses.

\textsuperscript{873} As well as statutory limits indicated in section 2 below, equity imposes certain limits. For example, "The duty to act in good faith (i.e. honestly and consciously) in respect of any trust matter cannot, of course, be excluded. To do so would make a nonsense of the trust relationship as an obligation of confidence." David Hayton, The Irreducible Core Content of Trusteeship, to be published in Oakley (ed) Contemporary Trends in Trust Law OUP Oct. 96.

\textsuperscript{874} (1992) 3 WLR 936. This was a Privy Council decision, on appeal from the Court of Appeal of Bermuda. The case concerned the practices of an estate agent and its failure to notify one vendor client that it also acted for a vendor of an adjoining property.

\textsuperscript{875} obiter, by Lord Browne-Wilkinson

\textsuperscript{876} Mason J in the case of Hospital Products International Pty. Limited v. U.S. Surgical Corp (1984)
a way as to alter the operation which the contract was intended to have according to its true construction".

The Law Commission discusses *Kelly* in the following terms:

"It confirmed that where a fiduciary relationship arises out of a contract, a clearly worded duty defining or exclusion clause will circumscribe the extent of the fiduciary duties owed to the other party."\(^{877}\)

The Report summarises the conditions that must be satisfied before the principle in *Kelly* may be relied upon\(^{878}\) and draws attention to its limits.\(^{879}\)

This approach was endorsed in the case of *Clark Boyce v Mouat*\(^{880}\). "A fiduciary duty...cannot be prayed in aid to enlarge the scope of contractual duties."\(^{881}\) Similar sentiments are expressed *obiter* in *Target Holdings Ltd v*

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877  p. 4.
878  "*Kelly* will provide a solution where the following conditions are satisfied. First, the duty defining and exclusion clause must clearly cover the transaction in question: it will have to do so unambiguously since it will be subject to the *contra proferentum* rule of interpretation. Secondly, in those situations where the relationship between the firm and client has altered over time, this altered relationship will also have to be caught by the clause. And thirdly, it must be the substance of the relationship between the client and the firm that is covered by the clause and not what the parties call it. If these three conditions are satisfied, then *Kelly* provides a way of solving the problems that arise from any mismatch between fiduciary rules, regulatory rules and market structure." pp. 85, 86.

879  (in relation to conflicts of interest) "However, there are three situations of conflict in which, despite *Kelly*, it will be necessary either to make appropriate provision in the contract or obtain the informed consent of the customer in order to avoid breaching a fiduciary duty. The first is where the firm is acting for two customers in the same transaction. The second is where there is a conflict between the firm's own interest and the duty which it owes to a customer and that conflict is more acute than that which arose in *Kelly*. ...The conflict would be more acute if, for example, (i) a firm has a direct beneficial interest in a transaction with a customer, such as where it sells its own property to a customer, ...The third situation is where there has been "iniquity". p. 24.

880  [1994] 1 A.C. 428. This was another Privy Council decision, on appeal from the Court of Appeal of New Zealand. The case concerned a claim against a solicitor; the plaintiff mortgaged her house to secure a loan to her son, and the solicitor acted for both of them.

881  per Lord Jauncey of Tullichettle, at 437.
Redferns. However, while fiduciary duties must conform with the contract, they are not entirely subsumed within it, for "...the essence of a fiduciary relationship is that it creates obligations of a different character from those deriving from the contract itself." 883

b. limitations of liability

There is longstanding authority that the terms of a fiduciary’s appointment may limit its duties. However, it is also clear from case law that trustees, as other fiduciaries, have a core minimum level of duty that cannot be excluded by any relieving provisions. Old authority indicates that liability for gross negligence and wilful default are inexcusable but modern authority indicates that liability for negligence and even gross negligence can be excluded if the exclusion is clearly brought to the attention of the settlor (client).

In any case, the minimum level of core duty that cannot be excluded is lower than that which global custodians customarily seek contractually to exclude, i.e. negligence and wilful default. Any limitation clause will be restrictively construed by the court and any doubt or ambiguity resolved against the fiduciary seeking to rely on it. It may also be prudent to draw clients’ attention

882 [1995] 3 WLR 352, per Lord Browne Wilkinson at 795: “But in my judgment it is important, if the trust is not to be rendered commercially useless, to distinguish between the basic principles of trust law and those specialist rules developed in relation to traditional trusts which are applicable only to such trusts and the rationale of which has no application to trusts of quite a different kind.”

883 Re Goldcrop Exchange Ltd [1994] 2 All ER 806 at 821. See also Henderson v Merrett [1994] 3 All ER 506 at 543.

884 See Wilkins v. Hogg (1861) ER 66 346.

885 See Wilkins v Hogg at 348.

886 The difference between negligence and gross negligence is indicated in Midland Bank Trustee (Jersey) Ltd v Federated Pension Service, 21 December 1995, at 44: the trustee’s conduct “was not mere negligence consisting of a departure from the normal standards of conduct of a paid professional trustee, but a serious, unusual and market departure from that standard which amounted to ‘gross negligence’.

887 In the case of Pass v. Dundas (1880) 43 L.T. 665 Bacon V.C. held that the effect of the decision in Wilkins v. Hogg was that an appropriate exemption clause “does protect a trustee from loss that may have been sustained in the course of administering the trust estate, unless you can impute to him gross negligence or personal misconduct”.

888 In Midland Bank Trust (Jersey) Ltd v FPS (1995) the Jersey Court of Appeal held that liability for gross negligence may be excluded unless prohibited by Statute.
to exclusion clauses prior to the execution of the custody agreement in cases where the client is not legally represented, particularly where it is sought to exclude gross negligence.\(^{889}\) However, provided they are adequately drafted, it may generally be assumed that these clauses are effective, subject to the comments below.\(^{890}\) \(^{891}\)

2. **Statutory Restrictions**

a. **Unfair Contract Terms Act 1977 ("UCTA")**

In accordance with Section 3 of UCTA, exclusion clauses relating to business liability for breach of contract contained in one party's written standard terms of business are subject to a test of reasonableness.

An exemption may be available as follows. Paragraph 1 of schedule 1 to the Act provides that "sections 2 to 4 of this Act do not extend to ... any contract so far as it relates to the creation or transfer of securities or of any right or interest of securities". This exclusion was designed primarily to assist brokers and not custodians. It does not clearly exempt the terms of the global custody agreement, as of course this relates to the holding and administration of...

\(^{889}\) "...there needs to be full frank disclosure...so that a fully informed consent can be given, because a fiduciary relationship exists even before the trust instrument is finally executed." David Hayton, The Irreducible Core of Trusteeship, to be published in Journal of International Trust and Corporate Planning.

\(^{890}\) See the unreported High Court judgment of Harman J in Galmerrow Securities Ltd & Ors v Nat. West Bank PLC 20 December 1990, in which a trust deed is considered which contained relieving provisions limiting trustee liability to losses resulting from its fraud and negligence. "However high a standard of skill and care is imposed by the general law, and I would wish to impose the highest standard on Trustee departments of major clearing banks, the duty has still to be defined by reference to the actual Trust deed in the case before the Court. In Bartlett's case (supra) no terms like those in the Trust Deed constituting the 22nd PAUT existed." (p. 35).

This view is endorsed by the Law Commission: "We stated in the consultation paper that a fiduciary could not exclude liability for fraud, deliberate breach of duty and, possible, gross negligence. Beyond that, our provision view was that, in general, no restriction operated as a matter of fiduciary law to prevent a fiduciary from contracting out of or modifying his fiduciary duties, particularly where no prior fiduciary relationship existed and the contract sought to define the duties of the parties." Law Commission Report No 236, December 1995, Cm 3049, Fiduciary Duties and Regulatory rules, p. 11.

\(^{891}\) Compare the position in Jersey, clarified in the recent decision of the Jersey Court of Appeal in Midland Bank Trustee (Jersey) Limited and Others v Federated Pension Services 21 December 1995. This case confirmed that higher standards are required from professional than non-professional trustees and that limitation clauses may be valid if they comply with statutory restrictions (Article 26(9) of the Trusts (Jersey) Law 1984 as amended prohibits exclusions of liability for fraud, wilful misconduct or gross negligence). Limitation clauses will be construed against the trustee.

- 235 -
securities as well as their transfer. However, this exemption may protect settlement side of the global custody service. 892

To the extent that the exemption is not available, the custodian's limitation clauses are subject to a statutory reasonableness test. 893 It might be argued that this test is satisfied in cases where terms in question are in market standard form. 894

b. *Unfair Terms in Consumer Contracts Regulations 1994. 895*

These regulations apply (in addition to UCTA) to terms which have not been individually negotiated, in contracts for the supply of goods or services by businesses to consumers. For this purpose, a consumer is a natural person (i.e. not a company or, probably, partnerships or unincorporated associations) who is acting for purposes which are "outside his business". Thus, terms in standard form global custody contracts with high net worth individuals who are not involved in investment business may be prima facie caught.

The Regulations imposes requirements of fairness and plain English.

3. **Particular Clauses**

Certain additional exclusions are customary in global custody agreements. Precisely what is included depends on the concerns and negotiating strengths of the parties. The following are important examples.

a. *force majeure*

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892 The view that UCTA applies to a limitation clause in some circumstances and not others may be supported by the case of *Micklefield v. S.A.C. Technology* (1991) 1 All ER 275. In this case the court emphasised that the exception applies to "any contract *insofar as* it relates to the creation or transfer of securities"es." at 281.

893 This is defined in Section 11 as the requirement "that the term shall have been a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made".

894 Section 2(2) of UCTA subjects exclusions of liability for negligence to the reasonableness test. It is fairly unusual for custodians to seek to exclude liability for negligence.

895 These came into force on 1.7.95, implementing the EC Directive on Unfair Terms in Consumer Contracts (93/13/EEC).
The global custodian's ability to discharge its duties may be particularly vulnerable to computer failure. Force majeure clauses (excusing performance where it is rendered impossible or impracticable) are very important. However, they cannot substitute practical measures such as disaster recovery systems and insurance.

b. consequential damages

In view of the judgment in Target Holdings Ltd v Redfens896 it is important for fiduciaries contractually to exclude liability for consequential damages; such provision must, however, be brought clearly to the attention of clients.

C. Liability for Third Parties

The global custodian is at the centre of a communications and service network. When losses occur to a client's portfolio, they will often be attributable, not to the global custodian itself, but to a third party. This section will consider two topical issues, namely the liability of the global custodian in respect of sub-custodian default and fraudulent instructions from managers.

1. Liability for Sub-Custodians897

One of the most commercially sensitive issues facing the global custodian is the extent to which it should stand behind its sub-custodians.

Many clients mistakenly believe that the law imposes strict liability upon custodians for the defaults of their delegates, but this is far from true. Where the sub-custodian is a nominee or close associate of the global custodian, it may be unrealistic for the global custodian to expect to escape liability.898 However,

896 [1995] 3 All ER 785, per Lord Browne Wilkinson at 794, 798: "...the common law rules of remoteness of damages and causation do not apply...The plaintiff's actual loss as a consequence of the breach is to be assessed with the full benefit of hindsight. Foreseeability is not a concern in assessing compensation..."

897 The power to sub-delegate safekeeping should be expressly reserved in the global custody agreement: "At present there is no general power to put trust investments into the name of a nominee otherwise than under section 7 of the Trustee Act 1925" (which relates to bearer securities). Law Reform Committee, Twenty-Third Report, The Powers and Duties of Trustees, p. 39.

898 This position is reflected in the SIB's proposals in its Custody Review
for independent sub-custodians, liability is much more limited. The Trustee Act 1925 contains important relieving provisions in respect of liability for third parties.

Section 30(1) limits liability for sub-custodians to the personal wilful default of trustee custodians. The term “wilful default” has been the subject of much debate. The term appeared in the statutory precursors to section 30, in which it was construed as meaning want of common prudence or negligence. However, a narrow interpretation was given in Re Vickery where the term was held to mean conscious breach of duty or recklessness as to whether there was breach of duty. This narrow interpretation has been criticised and in the later case of Bartlett v Barclays Bank Trust Co Brightman LJ held wilful default to cover “a passive breach of trust, an omission to do something which, as a prudent trustee, he ought to have done.” Therefore it would be prudent to take wilful default for this purpose to mean lack of ordinary prudence. On this basis, to escape liability under this section for third party losses, the global custodian must show ordinary prudence in the appointment and supervision of its global custodial network.

899 “A trustee shall be chargeable only for money and securities actually received by him notwithstanding his signing any receipt for the sake of conformity, and shall be answerable and accountable only for his own acts, receipts, neglects, or defaults, and not for those of any trustee, nor for any banker, broker, or other person with whom any trust money or securities may be deposited, nor for the insufficiency or deficiency of any securities, nor for any other loss, unless the same happens through his own wilful default”.

900 Section 31 of the Law of Property Amendment Act 1859 and section 24 of the Trustee Act 1893.

901 Underwood v Stevens (1816) 1 mer 712; Re Brier, (1884) 26 Ch D 238, 243; Re Chapman (1896) 2 Ch 763, 776; Speight v Gaunt (1883) 9 App Cas 1, 13-15, 22-23. These references are given in paragraph 2.1.6 of Trust Law Commission, Collective Delegation of Trustees' Powers and Duties, internal paper of the Trust Law Commission, October 1995. See also Underhill and Hayton p. 623

902 (1931) 1 Ch 572

903 The term was held to mean “...either a consciousness of negligence or breach of duty or recklessness in the performance of a duty.” Per Maugham J at 584. The narrower interpretation was followed by Hoffmann J in Steele v Wellcome Trustees Ltd (1988) 1 WLR 167, 174.

904 “It will shortly be seen that the traditional equitable meaning of “wilful default” extends to negligent conduct and such traditional meaning should have applied in section 30.” Collective Delegation of Trustees' Powers and Duties, op. cit., paragraph 4.1.5. See also Underhill and Hayton, p. 623

905 [1980] Ch 515, 546
Section 23(1) permits the appointment of agents, and exempts the trustee from liability from agents' default if employed in good faith. Again, global custodians should be cautious in relying on this provision in the light of Bartlett v. Barclays, as its terms may be construed strictly against them. Moreover, it applies to the defaults of a trustee's agents. In characteristic global custodial arrangements, the sub-custodians are not agents but principals. Moreover, the prudent interpretation of this sub-section is that it relates only to vicarious liability and does not affect the personal liability of the custodian, which remains governed by section 30.

Accordingly, the position implied by statute is probably that the global custodian is liable for losses caused by sub-custodian default, only where the loss is due to the failure of the global custodian to use ordinary prudence in appointing and supervising the sub-custodian, or where the loss is otherwise due to the global custodian's negligence (or, possibly, gross negligence) or wilful default. This assumes that the appointment of the sub-custodian was authorised by the terms of the global custody agreement; if it was not, it is unlikely that the global custodian will escape strict liability.

Global custodians should, therefore, take care in the initial choice of the members of their network, and in reviewing that choice from time to time. Criteria should include all matters affecting the safety of client assets, including

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906 "Trustees or personal representatives may, instead of acting personally, employ and pay an agent, whether a solicitor, banker, stockbroker, or other person, to transact any business or do any act required to be transacted or done in the execution of the trust, or the administration of the testator's or intestate's estate, including the receipt and payment of the money, and shall be entitled to be allowed and paid all charges and expenses so incurred, and shall not be responsible for the default of any such agent if employed in good faith".

907 See Law Reform Committee Twenty-Third Report, Cmd 8733, p. 36: "We think that the standard of care presently found in section 23(1) is not stringent enough." See also Underhill and Hayton at pp. 623, 624.

908 Any agency between the global custodian sub-custodians is avoided, in order to prevent a direct contractual relationship between the third parties and the global custody clients, which might in turn undermine the commercial position of the global custodian.

909 Contrast the wording of section 23(2), which relates to personal liability. The interpretation that section 23(1) is limited to vicarious liability accords with the pre-1925 position under the general law: "Before the Trustee Act 1925, while trustees were vicariously liable for the acts of unauthorised agents (and still are), it was clear that trustees who were authorised to delegate the carrying out of specific tasks to an agent were not vicariously liable for the acts of that agent but could be personally liable for their own acts in failing to select or supervise the agent with good faith and common prudence." Collective Delegation of Trustees' Powers and Duties, internal paper of the Trust Law Committee, October 1995, paragraph 4.1.1. See Fry v Tapson (1884) Ch D 268 and Re Brier, (1884) 26 Ch D 238, per Lord Selborne LC at 243.
local custodial and administrative arrangements and staff controls. These should be considered in the light of local law and market practice. In particular, the global custodian should consider the impact of local insolvency law on its ability to recover client assets in the event of the third party’s insolvency. Delegation by third parties should be carefully controlled.910

Global custodians sometimes take indemnities from sub-custodians. However, the usefulness of any such indemnity might be limited for the following reasons. The major risk associated with sub-custodians may be their credit risk; their insolvency would clearly affect the enforceability of an indemnity issued by them. Moreover, if the global custodian’s exposure is due to its breach of duty, an indemnity in respect of it may be enforceable, as discussed in section F.4 below.

2. Fraudulent Instructions

An important potential exposure to the custodian is the arrangement, customary in pensions business, where instructions come not from the client, but from a fund manager.

a. Bank America Writ

Following the Maxwell scandal, the pension trustees sued Bank America as custodian for implementing the manager’s instructions to make the free deliveries that led to the loss of the pension assets. Bank America has now settled the claim. It was not disputed that the instructions were technically valid.911 The basis for the claim was that the custodian’s suspicions should have been raised and, as a fiduciary, it should have reviewed the instructions and enquired into the circumstances surrounding them. This claim raises the suggestion that the custodian’s duties may

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910 Under the general rule, delegatus non potest delegare, the custodian must act personally and delegation and sub-delegation are not permitted, unless expressly provided for in the global custody contract, on the basis that the client is deemed to have chosen the custodian personally to carry out its duties.

For US clients, sub-delegation of custody of pension assets is restricted by regulations made under section 404(b) of ERISA and sub-delegation of custody of mutual fund assets by rule 17(f)(5) of the Investment Companies Act 1940.

911 Although it may be argued that fraudulent instructions cannot be valid instructions under a custody contract)
extend to oversight of the manager, or even co-management.\footnote{As the claim was settled out of court, these issues have not been judicially clarified.} The suggestion that the custodian is obliged to vet manager’s instructions is worrying for the custodian. Firstly, it is contractually obliged to obey instructions, so that any obligation to decline to obey certain instructions might put in breach of contract\footnote{As delayed settlement may put the manager into default and also prevent it from taking advantage of investment opportunities, damages may be significant.}. Secondly, in view of the high level of automation that is increasingly customary in settlement operations, any duty to review or subjectively appraise particular instructions may be impractical to discharge. In any case, the staff involved in settlement may be trained for administrative duties, and not in a position to exercise judgments as to the propriety of instructions.

There are strong arguments that the custodian is not under a general duty to review manager’s instructions,\footnote{Although it can be liable for dishonest assistance in breach of fiduciary duty: Royal Brunei Airlines [1995] 3 All ER 97} as follows.

\begin{enumerate}
\item \textit{Galmerrow}
\item The unreported case of \textit{Galmerrow Securities Limited & Others v National Westminster Bank PLC} (1990) considered the position of the trustee of an unauthorised unit trust scheme. Mr Justice Harman noted that the trust deed conferred exclusive power of and responsibility for management on the managers. “Plainly these terms are inconsistent with...”
\end{enumerate}

\footnote{The writ alleged that a number of terms were implied into the custody agreement, including the following:

\begin{enumerate}
\item ...(5) that BA would immediately inform the Trustees and if necessary each of the directors thereof of any instructions that it received in relation to the funds, which might involve risks to the assets under their management or alter the nature of their rights and duties and/or their performance thereof or which were abnormal, suspicious or otherwise out of the ordinary.
\item (6) that BA would not deal with the funds and securities that it held in any way which put them at risk or allowed them to be stolen or used for improper purposes or lost to the MGPS...” p. 27}
c. **Goode Report**

During September 1993 the Pension Law Review Committee, chaired by Professor Roy Goode, published its report on pension law reform. There is a section discussing the custody of pension assets and the desirability of using a custodian independent of the sponsor and the manager. The report concludes as follows "... whilst recognising the value of custodianship services, we do not consider that it would be right to require trustees ... to place pension funds assets with independent custodians." Part of the basis for this conclusion is "... the fact that the custodian exercises ministerial rather than managerial functions and has no duty to investigate the propriety of instructions given to it, which appear to be in order, unless it has specifically undertaken a monitoring function." "The use of custodians may well give the semblance of protection without the reality."

**d. conclusions**

Contractual provisions should be included in the global custody agreement confirming the ability to assume that technically valid instructions are in order and that there is no duty of oversight of the manager. However, it would be prudent for global custodians to assume

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915 p. 25.

916 This is of course a crucial issue, as the success of custodians in the years ahead may depend on their ability to provide services to occupational pension schemes.

917 p. 369.

918 p. 367. "The custodian will wish to see the provisions of the trust deed relating to the trustees' investment powers. When dealing with a fund manager the custodian should also verify the authority given to the fund manager, and, where that authority does not come direct from the trustees as a whole but from individual trustees or from a third party, the source of their power to confer that authority. But when these steps have been taken, the custodian is free to act on its instructions in the absence of circumstances putting it on enquiry that something may be amiss." p. 368.

919 p. 369.
that they may not escape liability for acting on evidently fraudulent instructions, and for this reason may consider implementing controls that alert them to free deliveries or possibly large transfers. Timely transaction reports to clients may also address risk.

D. Secret Profits

Section A.1 above indicated that, as a fiduciary, the global custodian is generally not permitted to profit from its position at the expense of the client. One aspect of this is that the custodian cannot be remunerated unless fees are expressly agreed with the client, although there is an implied right to recover reasonable expenses. Another aspect of the rule is that in general no profit to the custodian indirectly derived from its service to the client can be retained. While this rule can be modified by the informed consent of the client, any "secret profits" must be accounted for to the client.

Downward competitive pressure has reduced custodian fees to minimal levels, and the significant profits associated with global custody are no longer fee based, but derived from "cross selling". The global custodian may undertake discretionary stocklending of the clients' portfolios, and provide foreign exchange and derivative services, retaining significant profits in each case. These profits are not always expressly disclosed.

Many custodians take a middle course, and include provision in the global custody contract giving general advance disclosures relating to cross selling and associated profits.

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920 Because the contractual provision may not be wholly enforceable, care should be taken to ensure that "partial invalidity" boilerplate is also included (i.e. provision that, if any part of the agreement is invalid, the remainder will remain in effect).

921 "A trustee, even one rendering services of a professional nature, cannot charge for those services unless the trust instrument expressly so provides or a court authorises remuneration." Law Reform Committee, Twenty-third Report, The Powers and Duties of Trustees, Cmd. 8733, October 1982, p. 1.

922 "A trustee may reimburse himself or pay or discharge out of the trust premises all expenses incurred in or about the execution of the trusts or powers." section 30(2) of the Trustee Act 1925. Express provision is still customary, in order to avoid argument as to what is reasonable, and to specify "flat rate" expenses such as transaction charges which are a reasonable estimate of the custodian's expenses, to obviate the need to demonstrate actual disbursements equal to the charge.

923 (i.e. profits to which the client has not informedly consented)

924 See In re Brooke Bond Trust Deed [1962] 1 Ch 357. See also Bray v Ford (1986): The trustee is under a duty not to place himself in a position where his trusteeship duties and his personal interests may possible conflict.
In its Consultation paper\textsuperscript{925} the Law Commission casts doubt on such general advances disclosures, arguing that in order to establish informed client consent, a much higher level of detail than was customary, was necessary.\textsuperscript{926} However, in its subsequent report\textsuperscript{927} the Law Commission is more robust. It argues that \textit{Kelly} permits firms to rely on advance disclosures\textsuperscript{928}.

However, some clients who are trustees may fear that general advance consent may involve them in breach of trust to their beneficiaries.\textsuperscript{929} Further, a note of caution is sounded by the case of \textit{Glynwill Investments NV v Thomson McKinnon Futures Ltd}\textsuperscript{930}, where a foreign exchange dealer was held liable for breach of fiduciary duty, and was not able to rely on contractual provision which did not accord with the commercial realities of its client business.\textsuperscript{931}

The prudent approach would be to treat profits from cross selling in the same way as custody fees, and assume that they may only be retained if expressly detailed in the global custody agreement.

\section*{E. Conflicts of Interest}

\textsuperscript{925} \textit{Fiduciary Duties and Regulatory Rules}, May 1992

\textsuperscript{926} p. 128

\textsuperscript{927} December 1995

\textsuperscript{928} "We now believe that a sufficiently precise general advanced disclosure made in a contract will be effective provided that the contract clearly delimits the fiduciary duties owed to the customer and displaces the obligation to make full disclosure of all material facts, and the customer has not been misled as to the nature of the relationship between the parties." p. 47.

\textsuperscript{929} See Hayton, \textit{Developing the Law of Trusts for the Twenty-First Century} (1900) 106 LQR 87, 89.

\textsuperscript{930} 13 February 1992 (Unreported, Tuckey QC).

\textsuperscript{931} "This case also considered the extent to which the contract can determine the scope of fiduciary duties. The defendant firm was a foreign exchange dealer. It acted for the plaintiff in currency transaction, charging a commission and also, in some cases, taking a mark-up on the price at which it had bought in the market. It did not disclose the mark-up to the plaintiff. The plaintiff contended that the defendant was acting as its agent and was therefore liable to account for the mark-up. The defendant claimed that it was acting, as the contract between it and the plaintiff specified, as principal. However, the deputy judge concluded that in the light of the other evidence, including the agreement of commission and the market order method used by the plaintiffs, the trading relationship was one of principal and agent. The plaintiff was therefore entitled to recover the amount of the mark-up from the defendant." Law Commission Report, pp. 29, 30.
A trustee is under a duty not to place itself in a position where its trusteeship duties and its personal interest may possibly conflict. An important and growing function of custody securities is collateral. For reasons of administrative convenience, custodians are often asked to act in two capacities, both as custodian for their clients and as collateral trustee for their client’s secured creditors. The arrangement may be documented by one tri-party contract.

Section A.1. above referred to the undivided loyalty rule, which prevents the fiduciary from placing itself in a position where its duty towards one customer conflicts with its duty to another. Clearly, to be acting as fiduciary for the parties on both sides of a security interest involves such a conflict. The general rule that fiduciary duties can be modified by informed contractual consent, and that commercial contractual terms prevail over fiduciary duty, should be treated with some caution in this context. Careful drafting may adequately address the conflict in circumstances where the custodian has no discretionary powers or duties in relation to the security interest, but is merely obliged to act on the express instructions of the chargee. However, where it has any discretionary powers in relation to the management or enforcement of collateral on behalf of the chargee, its position may be untenable.

F. Consequences of Breach of Duty

In order successfully to sue a global custodian, a client must to establish liability. Apart from criminal liability, there are very broadly three general categories of civil liability under English law. These are, breach of fiduciary duty, breach of contract and tortious liability (negligence).

932 Bray v Ford [1896] A.C. 44

933 (and because the transfer of securities can involve delay, expense and tax)

934 In other words, the client both places its securities with the custodian, and charges them to the creditor, and the creditor appoints the custodian to act on its behalf in relation to the administration and enforcement of the charge.

935 (to which the client, the secured creditor and the custodian are parties)

936 These are the traditional heads of liability. A possible additional head is unjust enrichment. See, for example, Westdeutsche Landesbank Girozentrale v Islington Borough Council [1994] 1 W.L.R. 938. However, this additional head of liability is fairly speculative at the time of writing.
1. Breach of Fiduciary Duty

Very broadly speaking, a custodian incurs liability to the client where it is in breach of its fiduciary duties to the client and this breach results in loss to the client. The measure of this liability is to make good such loss. Remote or unforeseeable damages are not excluded, but there must be some causal connection between the breach of duty and the loss to establish liability. Liability is subject to contractual or statutory relieving provisions.

Statutory relief is in theory available under section 61 of the Trustee Act 1925, where the custodian has acted honestly and reasonably and ought fairly to be

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937 The discussion of liability that follows assumes that the custodian is a trustee. Broadly similar general principles govern the liability of a bailee.

938 This is essentially akin to the position at common law. See Target Holdings v Redferns [1995] 3 All ER 785, per Lord Browne Wilkinson at 792: "At common law there are two principles fundamental to the award of damages. First, that the defendant's wrongful act must cause the damage complained of. Second, that the plaintiff is to be put 'in the same position as he would have been in if he had not sustained the wrong for which he is now getting his compensation or reparation'...Although, as will appear, in many ways equity approaches liability for making good a breach of trust from a different starting point, in my judgment those two principles are applicable as much in equity as at common law."

939 Nor is there any duty on the plaintiff to mitigate its losses by litigation: see Target, at 799, quoting from the judgment of Hoffmann LJ Bishopsgate Investment Management Ltd (in liq) v Maxwell (No 2) [1994] 1 All ER 261: "...it is sound law that a plaintiff is not required to engage in hazardous litigation in order to mitigate his loss."

940 See Target, per Lord Browne Wilkinson at 794. "Even if the immediate cause of the loss is the dishonesty or failure of a third party, the trustee is liable to make good that loss to the trust estate if, but for the breach, such loss would not have occurred. ...Thus the common law rules of remoteness of damages an causation do not apply. However, there does have to be some causal connection between the breach of trust and the loss to the trust estate for which compensation is recoverable, viz the fact that the loss would not have occurred but for the breach."

In Target the issue was breach of an equitable duty of care and not breach of core fiduciary duty. This latter issues is considered in the following cases.

The insistence on some causal connection alters the earlier rule that loss flowing from non-disclosure by a fiduciary attracts strict liability (Brickenden v London and Loan Savings Co [1934] 3 DLR 465 at 469). However, in respects of active misrepresentations, liability remains strict: Bristol and West Building Society and May May & Merrimans [1996] 2 All ER 801.
excused. However, it is considered unlikely that such relief would be granted to a professional trustee such as a global custodian.

A custody client may have remedies against parties other than the global custodian in certain circumstances. Equitable tracing may be available. In addition a custody client may be able to sue persons holding or having held their custody assets as constructive trustees, and (even where the defendant does and has not held the assets) there may be liability for dishonest assistance. (This concept may impose liability on a fund manager who, for example, co-operates with a custodian in settling a purchase of securities into

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941 "61. If it appears to the court that a trustee, whether appointed by the court or otherwise, is or may be personally liable for any breach of trust, whether the transaction alleged to be a breach of trust occurred before or after the commencement of this Act, but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions from the court in the matter in which he committed such breach, then the courts may relieve him either wholly or partly from personal liability for the same."

Similar provisions in relation to company directors are contained in section 727 of the Companies Act 1985 (directors etc).

942 "Although there is no doubt about the court's jurisdiction to grant relief under section 61 to a trustee who is remunerated, there appears from the cases to be a market reluctance to do so." Law Commission Report, Fiduciary Duties and Regulatory Rules, December 1995, p. 95

The 23rd Report of the Law Reform Committee looked at the whole question of the powers and duties of trustees and considered the issue of whether it was desirable to incorporate the distinction between professional and voluntary trustees into statute. It concluded that this was not necessary, stating that Section 61 was an adequate statutory provision to allow this difference to be recognised. The courts would be far more likely to give relief to a voluntary trustee under Section 61 than to a professional Trustee.

943 "A constructive trust of property is a trust imposed by equity in respect of property on proof of a variety of special circumstances...where equity considers it unconscionable for the owner of particular property to hold it purely for his own benefit. It confers a proprietary right on the plaintiff...It is now apparent that a constructive trust is a remedial institution which equity imposes to preclude the retention or assertion of beneficial ownership of property...to the extent that such retention or assertion would be contrary to some principle of equity." D. J. Hayton, Underhill and Hayton, Law Relating to Trusts and Trustees, 15ed, Butterworths, London, 1995, pp. 42, 43.

The case of Brinks Ltd v Abu-Saleh and Others (No 3) (Times 23 October 1995) considered the decision in Brunei: confirmed that in order for a person to be liable in equity as an accessory to a breach of trust it was necessary for him to have given the relevant assistance in the knowledge of the existence of the trust or, at least, of the facts giving rise to the trust. Mr Justice Rimer "considered Royal Brunei Airlines, in particular p 76E, and said that he did not consider that the Privy Council intended to suggest that an accessory could be made accountable to the beneficiaries as a constructive trustee regardless of whether he had any knowledge of the existence of the trust."

944 See Royal Brunei Airlines v Tan [1995] 3 All ER 97, per Lord Nicholls at 109: "A liability in equity to make good resulting loss attaches to a person who dishonestly procures or assists in a breach of trust or fiduciary obligation. It is not necessary that, in addition, the trustee or fiduciary was acting dishonestly...". Unlike in the criminal law, dishonesty for this purpose is an objective standard: see 105, 106.
a street name, if it knows that such an arrangement is in breach of the terms of
the custody agreement.)

2. Negligence

“Negligence as a tort is the breach of a legal duty to take care which results in
damage, undesired by the defendant, to the plaintiff.” 945

The measure of damages for negligence or other torts is the award which is
necessary to put the plaintiff back into the position it would have been in had
the tort never occurred (i.e. it is retrospective) 946

There are limits to the ability to recover damages for economic loss in
negligence. 947

The relationship between negligence and breach of fiduciary duty is discussed
by Lord Browne Winkinson in Henderson v Merrett 948. Liability in negligence
is derived from fiduciary duties of care. The two heads of liability cannot be
claimed as alternatives, for the tortious and fiduciary duties of care are in
essence the same. 949 The judgment extends the principle in Kelly v Cooper to
tortious liability: just as fiduciary duties may be limited and determined by
contract, so tortious duties may be so limited and determined. 950

946 "The basic principle for the measure of damages in tort is that there should be restitution in integrum. Apart
from the special cases we have considered, "where any injury is to be compensated by damages, in settling the
sum of money to be given for reparation of damages you should as nearly as possible get at that sum of money
which will put the party who has been injured, or who has suffered, in the same position as he would have been
in if he had not sustained the wrong for which he is now getting his compensation or reparation" [Livingstone
v Rawyards Coal Co. (1880) 5 App CAs 25, 39 per Lord Blackburn]. Winfield and Jolowicz on Tort, 14ed,
947 See Hedley Byrne v Heller (1964) A.C. 465. A huge literature has been written on this topic.
948 [1994] 3 All ER 506 at 543
949 At 543
950 At 544
However, contractual and tortious liability can be concurrent. 951

3. **Breach of Contract**

"Damages for a breach of contract committed by the defendant are a compensation to the plaintiff for the damage, loss or injury he has suffered through that breach. He is, as far as money can do it, to be placed in the same position as if the contract had been performed." 952 In other words, the approach is prospective (in contrast with the retrospective approach for assessing tortious damages).

Compliance with a contractual duty is not a defence to liability for breach of fiduciary duty, where the two conflict. Hence the importance, for example, of modifying the fiduciary duty of disclosure of all relevant information to one client, in view of the contractual and fiduciary duties of confidentiality to another client.

4. **Nexus**

Where a custody client suffers loss due to the default of a sub-custodian, its ability to recover damages (whether for breach of fiduciary duty, breach of contract or negligence) will depend on its ability to demonstrate that it is in a direct relationship with the defendant. 953 Such relationships can be established between the client and the global custodian, but no liability may arise there because the global custodian is not at fault (unless it was in breach of its duty of care in appointing or supervising the sub-custodian). There may be fault at sub-custodian level, but no liability, because no relationship on which to establish duty owed to the client. In an intermediated product such as global custody, the client has no direct nexus with the sub-delegates responsible for losses; therefore duty and fault may be unlikely to coincide in the same person, the client is more exposed that in a service where there is no sub-delegation.


953 Because, under English law, fiduciary duties only arise where there is a relationship of special trust, contractual duties only arise where there is privity of contract, and negligence can only be established where duties of care are owed.
5. Indemnities for Breach of Duty

Where a manager wishes the global custodian to act in breach of its duties to its client (for example by appointing a sub-custodian in a jurisdiction where it cannot prudently do so) the manager may offer the global custodian an indemnity in respect of the global custodian's exposure for that breach. The global custodian should treat this with caution, as such an indemnity may be unenforceable.\textsuperscript{954}

Chapter 9. Conclusions

The computerisation of global custody has cut across traditional legal analysis. Computerised securities cannot be negotiable instruments (chapter 3). The lack of a tangible and allocated subject matter takes custody beyond the scope of bailment (chapter 40).

This work has considered this problem and has suggested that the solution to it comes from two sources. Firstly, conflict of laws: as global custody operates cross-border, some of the problems posed by computerisation under English domestic law are cured by private international law. These include questions of integrity of transfer, formalities of transfer and negotiability (chapter 6).

Secondly and more importantly, the law of trusts. Equity succeeds (where the common law and the law merchant fail) in meeting many challenges posed by computerised custody. These include the achievement of divided ownership without possession (chapter 4) and without individual allocation (chapter 5). The enormous commercial value of the law of trusts rests partly on its synergy with the rules of private international law: the latter's emphasis on lex situs and the former's ability to place the situs of certain trusts with the trustee (chapter 7).

The importance of equity in solving the legal problems of global custody accords with the argument that, through electronic custody, bearer securities have become registered securities which, traditionally, are equitable (chapter 3). Both developments reflect the historic role of equity in permitting commercial law to adapt to developments in commercial practice where the common law is too inflexible.(chapter 3)

It is appropriate that the computerisation (and therefore the dematerialisation) of custody securities should take us into the realms of equity, for equitable property has been described as if it were itself a species of dematerialisation.955

It is also appropriate that equity should support the modern global custodian, because of the obstinacy of equity in resisting the distinction between personal and proprietary rights. This

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955 duplicating the corporeal world with an incorporeal shadow. "We are to speak of the rights of ... certus que trust...[They] had an "estate", not in the land, but in "the use". This may be "An estate in fee simple, an estate for life, an estate in remainder" and so forth. We might say that "the use" is turned into an incorporeal thing, an incorporeal piece of land; and in this incorporeal thing you may have all those rights, those "estates", which you could have in a real, tangible piece of land." Maitland Selected Essays, Cambridge University Press, 1936, Trust and Corporation, pp. 164, 165. Equally the doctrine of equitable tracing "converted the 'trust fund' into an incorporeal thing, capable of being 'invested' in different ways." p. 172.
distinction has been fundamental in Western property law since Justinian. However, an interest under a trust resists it (chapter 7).

In an electronic environment, where rights in securities are held through multi-tiered, fungible and intangible arrangements, the assertion of a right in rem is almost fanciful. In this context, the only functional importance of the concept of property is avoidance of intermediary insolvency risk, and the trust achieves this. In its failure to take the ancient point that personal and proprietary rights are fundamentally different, equity anticipated computers.

Equity, then, provides the appropriate jurisprudential base for global custody. However, the day to day legal needs of global custodians and their clients are more practical than theoretical. A pragmatic approach to the enforcement of security interests in custody securities is essential (chapter 7). Above all, the drafting of the global custody contract is the most important factor in defining the duties and liabilities of the custodian (chapter 8). More broadly, the role of jurisprudence in global custody and generally in commercial law must be understood. Although expressed in terms of abstract principles, commercial law is not theoretical philosophy and an abstract approach will not take one far (chapter 2). Commercial law is a pragmatic technique for resolving concrete disputes. It follows events, in two senses. Firstly, legal theory is derived from the facts of the cases that make up commercial law. It is not an a priori discipline, and the correct direction for legal reasoning is "bottom up" rather than "top down." It follows, secondly, that commercial law adapts well to changes in commercial practice.

Moreover, the commercial and financial markets have always been able to tolerate a large measure of legal uncertainty. Just as the commercial revolution of the late middle ages was able to take place without a common law concept of assignable debt, and the industrial revolution

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956 The distinction organises the layout of Justinian's Institutes, Blackstone's Commentaries and Dicey's The Conflict of Laws alike.

957 "[The trust] was made by men who had no Roman law as explained by medieval commentators in the innermost fibres of their minds." Maitland, Selected Essays, Cambridge University Press, 1936, The Unincorporated Body, p. 130.

958 "...the fact remains that modern securities markets have moved so far beyond the movement of pieces of negotiable paper that the property law construct is inadequate and unworkable." C.W. Mooney, Beyond Negotiability, Cardozo Law Review, [1990] Vol 12, 305 at 303. In this article, which informed the revised draft 8 of the UCC, Professor Mooney suggests a securities law based not on property but on priority.

959 "Also it is to be remembered that the making of grand theories is not and never has been our strong point." Maitland, Selected Essays, Cambridge University Press, 1936, Trust and Corporation, pp. 218, 219.
took place without developed company law (chapter 3), so the computer revolution of the late 20th century has not been, and did not need to be preceded by a full legal account of itself. The complete legal account of computerisation in general, and of global custody in particular, will follow financial practice. This work has suggested a direction in which, in this jurisdiction, it may develop.