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On pledging or assigning under Spanish law ISDA Master Agreement claims subject to English law

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A claim arising from an ISDA Master Agreement may be pledged or assigned subject to Spanish law.

1. Case

Herein we present a hypothetical case as generically as possible. The debtor of financing granted by banks has its registered office in Spain. The banks may or may not have theirs in Spain, or some may and others not. The debtor, in turn, is a counterparty to a derivative subject to an ISDA Master Agreement and English law. The counterparty of the derivative may be a bank of the financing or a third party and, for greater externalization, we assume that it does not have its registered office in Spain or in the jurisdiction chosen as governing law under the ISDA Master Agreement.

The question is as follows: can the debtor and banks pledge under Spanish law a contingent claim in favour of the debtor against the counterparty of the derivative?

The answer is an emphatic yes.

2. Rome I

The first premise, indisputable at least in Spanish law, is that a pledge of claims is a type of assignment of claims, an assignment of claims by way of security, both being equal in Spanish Law.

Below we reproduce Art. 14 of Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I):

> *Voluntary assignment and contractual subrogation*
>
> 1. *The relationship between assignor and assignee (...) shall be governed by the law that applies to the contract between the assignor and assignee under this Regulation*
>
> 2. *The law governing the assigned or subrogated claim shall determine its assignability, the relationship between the assignee and the debtor, the conditions under which the assignment or subrogation can be invoked against the debtor and whether the debtor's obligations have been discharged.*
>
> 3. *The concept of assignment in this Article includes outright transfers of claims, transfers of claims by way of security and pledges or other security rights over claims.*

The relationship between the pledgor (assignor) and pledgee (assignee) is governed by the law determined under Rome I. This means that if the parties have chosen a certain law (the Spanish law, in this case), that is the law that governs the relationship between the debtor and the banks (Art. 3 Rome I), without resort to alternative factors.

This law may also extend to the form of the contract, in accordance with Article 11 Rome I, according to which the contract is valid as to its form if satisfies the formal requirements of the law which governs it in substance. However, this is not the only rule on the form of contract; the contract is also valid if the form provided for by the law of the country where it was concluded is respected. Thus, if the law governing the financing is Spanish law, the pledge would need to be recorded in a notary-attested agreement, but if the contract is entered into in a country that does not require this formal requirement, it does not cease to be valid. But if the pledge contract is entered into in Spain, it may be executed under the Spanish form of a notary-attested agreement, even if the pledge is subject to English law (!) and even if the underlying relationship is subject to English law.

Please note that particularities relating to the notarial form, or other special form, of the transaction in question are covered by Art. 11.

Article 11

Formal validity

1 A contract concluded between persons who, or whose agents, are in the same country at the time of its conclusion is formally valid if it satisfies the formal requirements of the law which governs it in substance under this Regulation or of the law of the country where it is concluded.

(...)

5. Notwithstanding paragraphs 1 to 4, a contract the subject matter of which is a right in rem in immovable property or a tenancy of immovable property shall be subject to the requirements of form of the law of the country where the property is situated if by that law:

a) those requirements are imposed irrespective of the country where the contract is concluded and irrespective of the law governing the contract; and

b) those requirements cannot be derogated from by agreement.

However, it is the underlying relationship between the debtor and the counterparty that will determine whether the claim can be assigned or pledged, what the precise requirements for the assignment are and the defences that the counterparty can rely on against the debtor, as per the cited Art. 14(2) Rome I.

There has been a lot of academic commotion as to whether Art. 14 Rome I governs only the obligational effects or also the "real legal effects". We believe that this is a dispute without substance, notably fed by legal systems, such as the German one, where there is a differentiation of effects between the obligatory contract of assignment (*Zession*) and the actual contract producing the transfer effect (*Abtretung*).

Indeed, the real legal effect par excellence of the assignment is the transfer of the claim (of the "legal title" to the claim). This being the substance of the assignment, it cannot be said that the question of the time and manner of the transfer of legal title to the claim is not regulated in Art. 14(1) Rome I, because then Art. 14(1) would have no content at all. The assignment of a claim subject to Spanish law (in our case, assignment by way of security) constitutes an immediate transfer of the asset, the agreed effectiveness of the assignment as a contract consisting of this. Obviously, the underlying relationship (debtor-counterparty) will determine, together with the debtor-banks hedging relationship, if and how the claim can be assigned.

3. Other third parties

In addition to the main characters we have identified above, we can introduce other characters in the scenario arising from the assignment.

Let us imagine that the debtor is also, for any reason, under an obligation to a third creditor (e.g., a former spouse to whom the former pays alimony). As such party is not named in Art. 14 Rome I, one could presume that the assignment or pledge would only be effective against the same by virtue of another law that determines the real legal effects (enforceability of the assignment or pledge). And what would this law be? The *lex rei sitae* of the claim. And what is this? The law of the domicile of the counterparty of the derivative, which can be any one, or the law applicable to the assigned-pledged claim (English, in our case)?

Although it is not clear if it is limited (as would be logical in the context) to the financial collateral of Royal Decree-Law 5/2005 or if it affects all claims, Art. 17(3) of the latter piece of legislation states as follows:

> *Where the subject matter of the guarantee is a claim, the law applicable to the effectiveness against the debtor or third parties of the assignment or pledge shall be the law governing the assigned or pledged claim.*

The above provision is poorly structured. At first sight it seems to say that the law of the assigned or pledged claim is the law that has to be applied in the construction of (assignment, pledge) contracts that produce real legal effects (ownership, enforceability against third parties of the assignment). That is to say, it would be the English law according to which a pledge of the claim would have to be granted against the counterparty.

But the provision does not intend such a thing, but to reaffirm the validity of Art. 14(2) Rome I. In effect, it is the law of the debtor-counterparty relationship that determines whether the claim can be assigned "under ownership" or "as a pledge" to banks. Which is obvious. What the provision says, moreover, is that that underlying law also determines whether the claim has also been assigned against a third creditor. It says nothing about how and under what law the pledge must be granted.

Therefore, the "real" effects against the third creditor is something that undoubtedly has to be settled by one of the two laws considered in Art. 14 Rome I, and by no other.

Let us introduce now a fourth creditor, a creditor of the assignee or pledge holding banks. It makes no rational sense for this creditor to discuss the existence of a law, other than Art. 14(1), in order to deny that its own debtor is the holder of the assigned claim.

Let us imagine a fifth creditor, of the counterparty for any relationship (an agency contract). If the assignment or pledge is unenforceable on the counterparty, then it is also unenforceable on the fifth creditor. But this fifth creditor has no legitimate interest in the assignment or pledge being granted according to one law or another. With one exception: that the law of the domicile of the counterparty (not the law of the assigned claim!) requires that the assignment or pledge be registered in a Registry in order to be effective. Then, and only then, a new law enters the scene, and it is not precisely the law of the assigned claim, but the law of the domicile of the counterparty, because of the requirement of territoriality of any registration system.

We could represent other situations in which a second assignee or pledgee appears together with the banks. Once again, the effects of this double assignment could be settled without leaving the universe of Art. 14 Rome I or seeking a special law for the real legal effects.

4. The "law of the pledge" and the law regulating the "effectiveness of the pledge"

Even if the law regulating the "effectiveness" of the pledge or assignment vis-à-vis third parties is (as intended by Art. 17(3) of the aforementioned Spanish law) the law regulating the assigned claim, this does not mean that the pledge or assignment must be granted "in accordance" with this law. It is enough for one or the other to be "effective" also under this law. The English law governing ISDA Master Agreements does not require City lawyers to grant (and charge fees for) the ISDA Master Agreement claim pledge because such must also be "effective" under English law. In fact, any assignment, granted in any way, and any pledge, granted in a notarial document, subject to Spanish law, are "effective" pledges and assignments under English law, which does not demand requirements for effectiveness beyond those that the transaction already entails.

5. EU regulation proposal

The European legislator has drawn up a proposal for a regulation that seeks to regulate precisely the third-party effects of assignments and pledges. This is the Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of assignments of claims of 12 March 2018 (COM(2018) 96 final), which introduces a provision of applicable law along the following lines:

> 1. *Unless otherwise provided for in this Article, the third-party effects of an assignment of claims shall be governed by the law of the country in which the assignor has its habitual residence at the material time.*
>
> 2. *The law applicable to the assigned claim shall govern the third-party effects of the assignment of:*
>
> *a) cash credited to an account in a credit institution;*
> *b) claims arising from a financial instrument.*

Leaving aside the already explained uselessness of a rule in this field, the *ratio* of the solutions adopted deserves some comment. If we look at the Explanatory Memorandum to the Proposal, the general rule of paragraph 1 (habitual residence of the assignor) is justified in that it is easily predictable, both for the assignee and for third parties concerned; it works well when a plurality of future or present claims is assigned but subject to different laws and will normally coincide with the law applicable to the insolvency of the assignor, thus avoiding problems of adjustment with the insolvency legislation. In addition to that, it is the solution retained in the United Nations Convention on the Assignment of Receivables in International Trade. This excludes the third-party effects of the assignment of cash credited to an account in a credit institution, which are governed by the law applicable to the assigned claim, which is to say that the lex rei sitae factor is adopted, since that law will, at least normally, be the law of the place where the branch in which the cash is deposited is located.

The problem arises when we come to the second of the exceptions (claims arising from a financial instrument). Again according to the Explanatory Memorandum, subjecting the third-party effects of assignments of claims arising from financial instruments to the law of the assigned claim is justified in that it *is essential to preserve the stability and smooth functioning of financial markets as well as the expectations of market participants. These are preserved as the law that governs the financial instrument from which the claim arises, such as a derivative contract, is the law chosen by the parties or the law determined in accordance with non-discretionary rules applicable to financial markets.* This is but gibberish. The reality behind said arguments is that there is a very clear sectoral interest: it is not so much the stability of the financial markets that would be preserved as that of English legal operators. The exception ensures the application of English law, which will normally govern the financial instrument, with the obvious intention of withholding part of the business - that of the assignment over those financial instruments - for the legal operators on the departing island. The adoption of a rule is thus proposed, which is provided as indispensable, to ensure the satisfaction of the interests of a State which is on the verge of withdrawing from the European Union without a deal. It is not that the European rules of applicable law must necessarily lead to the legal system of a Member State - quite the contrary, all those adopted so far affirm their *erga omnes* nature - but less so should they guarantee in advance a State the application of its law, thus reserving for it "its" piece of the business. It is far more appropriate to adopt a solution for these cases similar to that provided for securitisation cases: the choice by the assignor and the assignee of the applicable law between the law of the assignor's habitual residence and the law of the assigned claim.

Note, however, that, like Art. 17(3) of our Royal Decree-Law 5/2005, the rule does not regulate the granting of a pledge (the assignment contract), but the third-party effects of the assignment, so that not even if the regulation is finally adopted, keeping intact the wording of the proposal, will the intended purpose succeed: the assignment contract will be subject to the law applicable by virtue of Rome I and will be valid not only if the form of applying that law is respected, but also if it is subject to that of the place of conclusion, so that, even if sub-

ject to English law, it can be concluded in Spain, in accordance with the Spanish application, without the rule adopted with regard to these so-called third-party effects hindering such conclusion.

6. The "law" of the underlying relationship

Although we are speaking of the "English law", we should not lose sight of the fact that the underlying instrument between the debtor and the counterparty is the ISDA 2002 Master Agreement, which is not a "law" in the sense of conflict rules. It is not even "English law", but a contract, the interpretation and effectiveness of which, in respect of that not provided for by the ISDA Master Agreement, is governed by English law.

If a (contingent) claim arising from the derivative is not assignable, or is assignable subject to conditions, according to the ISDA Master Agreement, such conditions do not arise from "English law" but from the contract, and it would be the same if such document could be copied and embedded in Spanish law as a "contract". Moreover, it would also be so if the assignment or pledge of the claim arising from the derivative were granted in accordance with English law.

Of course, the ISDA Master Agreement could establish that the contingent claim can only be assigned or pledged under English law, but that is not the case.

What Art. 7 of the ISDA Master Agreement states is this:

> *7. Transfer*
>
> *Subject to Section 6(b)(ii) and to the extent permitted by applicable law, neither this Agreement nor any interest or obligation in or under this Agreement may be transferred (whether by way of security or otherwise) by either party without the prior written consent of the other party, except that—*
>
> *a) a party may make such a transfer of this Agreement pursuant to a consolidation or amalgamation with, or merger with or into, or transfer of all or substantially all its assets to, another entity (but without prejudice to any other right or remedy under this Agreement); and*
>
> *b) a party may make such a transfer of all or any part of its interest in any Early Termination Amount payable to it by a Defaulting Party, together with any amounts payable on or with respect to that interest and any other rights associated with that interest pursuant to Sections 8, 9(h) and 11.*
>
> *Any purported transfer that is not in compliance with this Section 7 will be void.*

This rule belongs to the underlying relationship, that which exists between the debtor and the counterparty, and which, according to Art. 14(2) Rome I, determines whether the claim can be assigned or pledged. But not if it can be so by Spanish or English law, but if it can be so in general, regardless of which law governs the underlying claim and which law governs "third-party effects".