Governing law of contracts: list of 25 points comparing English law and those of EU civil law member states

By Philip Wood

Edited version 7 July 2021 from text of a private message

Dear xxxxx

There is quite a lot of discussion going on with the governing law issue which we were debating earlier. I have got quite good data on the issues for most of the countries and, if you ever want a background chat on any of them informally, please do get in touch: mobile 07785500831, email: philipwoodcbe@gmail.com. I can also locate where the point is dealt with in my 2019 books in nine volumes on the law and practice of international finance which would not necessarily be easy by a search.

Law firms have a duty to advise their clients objectively on contract governing law pros and cons and indeed that discussion has historically been very frequent in my experience. Also the senior management of banks and other financial institutions have strict duties regarding risk control. These duties are both corporate and embedded in nearly every line of the regulatory codes. There is no room for politics or legal nationalism: law firms and banks obviously have to be above that. In my view, the choice of a governing law of major financial contracts does involve a consideration of relevant risk factors.

The choices legal systems make in the European region are generally well within the spectrum of reasonable debate so it is not a question of right or wrong. But it is a question of suitability for the case in hand and a question of the risks created by supporting this or that different legal policy objective. The parties may have different preferences for their contracts. Legal systems have different ideologies and made different choices in history. Hence there is a dramatic difference in the allocation of risks, eg between pro-debtor or pro-creditor. Parties have a free choice of the governing law of their transaction - a choice which most legal systems recognize. There is also a healthy competition between legal systems.

Clients want to know what they are getting. That means that these days we have to comparative lawyers as best we can, or at least try and understand broadly what is going on elsewhere in the world.

My list of 25 of the main points on the civil law systems in the EU compared to English law are set out below. The application depends on the jurisdiction and they don't apply to all the jurisdictions. I deal only with wholesale markets, not consumers, and only with private commercial and financial law. This is just a bullet-point list without detailed commentary. There are plenty of other points so this is a selection.

Generally English law is either bullet-proof or highly favourable on all these points, but according to my researches, extensively documented in the nine volumes of my 2019 books, none of the EU civil systems satisfies them all, and most of them are deficient to various degrees in most of them. Space does not allow me to set out in detail which point applies to which jurisdiction or the exceptions.

In the case of the Greek bankruptcy 2012, where there was a dispute about the governing law of Greece's new bonds, a memo was written on behalf of the bondholders by a team, including me, which showed that all 17 of the eurozone member states failed on one or both of two tests essential for the deal at the time (Article VIII 2b of the IMF agreement on the foreign recognition of exchange controls and the availability of a trustee for bondholders). English law met both tests convincingly without ifs or buts. It was not necessary to adduce other points since these two points closed the debate.

Anecdotal evidence suggests that English and New York law have about 80 per cent (in roughly equal shares) of the governing law market for international financial contracts (such as syndicated bank credits, international bond issues and derivatives) and long-term trade agreements – they are international public utilities.

About 85 percent of the world's 320 jurisdictions are based on English common law, Napoleonic or Roman-Germanic in the ratio of roughly 40, 30, 20, with 10 for others. The Napoleonic systems are the most distant on the majority of the points compared to the English common law group, with the Roman-Germanic group often occupying a middle position between the two. Ireland and Cyprus are the two common law jurisdictions in the EU: I exclude them.

EU carve-outs from their traditional positions, eg in favour of financial markets, are often bewildering. Separating a central fortress, such as a clearing system, from the rest of the ambient countryside can leave holes in the wall.

My 25 selected points are:

- Weak or absent **insolvency set off** and netting in many EU civil law member states. Some have a run-off of the limited solvent insolvency rules into insolvency, but none have the mandatory and all-encompassing rules of English insolvency set-off which is crucial for risk reduction via netting. Note that in the EU the governing law can validate set-off according to the law of the debt owed to insolvent so it is best to choose English law for this issue. The latest EU restructuring directive kills universal netting, outside carve-outs, because of stays on contract terminations. Systemic. Vast amounts involved, eg the foreign exchange market runs into trillions. See world summary in chapter 9 of vol 5 of my 2019 books.

- **Security interests**. Weak and hard to enforce in most of the EU jurisdictions. A huge subject. Systemic. See world summary in chapter 2 of vol 3 of my 2019 books.

- Protections under **carve-out statutes** in the EU, like the FCD and the SFD, are generally impenetrable and limited, e.g. set-off and security, i.e. a reluctant privilege not generally available as they are in England. Crucial in financial markets. The carve-outs are inaccessible and intricate. In addition, conflict of laws issues make it even more unrealistic for traders to know what the position is. They can't check opaque and technical legal opinions or grasp the detail in the split-second operations on the trading floor, nor indeed can even the experts. Systemic.

- **Trusts**, i.e. assets held by the trustee are immune from the private creditors of the trustee on its insolvency. Very patchy, partial (such as securities only or only securities in the settlement system) and complex in the few member states which allow them. France has introduced a registered trust. So is custodianship of securities as effective as the trust in the other jurisdictions? Ring-fenced nominee companies are not the same. Trust recognition can be improved by English governing law, e.g. under Hague 1985 (Italy) or local statute (Lux) or judicial recognition of foreign trusts (France and others). Systemic. Colossal amounts involved. See world summary of trusts in chapter 13 of my 2019 books. One consequence is that few civil law countries have the concept of restitutionary tracing through mixed bank accounts for mistaken of embezzled money (constructive trust) so that the perpetrator's creditors are enriched. The effect is that, outside unsatisfactory carve-outs, nearly all EU member states do not honour *universally all three* of the super-priority claimants on insolvency (which is when it matters), i.e. insolvency set-off, security interests and the trust, although some might honour one or two of them. English law honours all three – a major distinctive factor. All of these afford enormous advantages in risk reduction. Without them, financial markets, on which trade depends, would come to a halt. Financial markets are at least 100 times bigger than trade markets.

- **Contract unpredictabilit**y, e.g. generalized "good faith," "good morals" or other statutory principles allowing overriding of agreed terms by the court. You don't necessarily get the contract you negotiated, depending on the judge's view of what is fair. The parties can't therefore allot their own risks in the contract as they wish – this allotment of risks may well depend on many other factors, eg pricing and marketability at the time. Law on this was codified in France recently but the principles are common elsewhere in EU. The difference between good faith in England and in some EU member states and the resulting interference in the contract can be dramatic. You could call it bad faith because one party insists that the courts override the agreement. Some examples next. Can be critical in many circumstances.

- **Immediate terminations** often not honoured, even for non-payment, so that the court can reschedule. Crucial for central counterparties in netting systems and financialmarkets. Can be a systemic issue. Non-punctual payments without a discipline to enforce them can be devastating across the board. Even strawberry pickers for Tesco need to be paid on time. Do you wait three days, three weeks, three months? Who knows? If you, say, enforce security or repossess a ship too early, there could be large liability. English law allows the parties to fix their own termination rights and grace periods if they want.

- **Compulsory disclosures before contract**: voidable if not. Completely unrealistic in fast-moving markets. Dangerous for guarantees, eg France. English law does not require pre-contract disclosure except in special cases, such as insurance.

- **Non-binding mandates** and heads of agreement can attract legal liability, despite clear exclusions, eg "subject to contract.

- **Exclusion of arranger liability** ineffective. Large amounts at risk for individual institutions.

- **Spirit, not letter, of the agreed deal**. Banks don't necessarily get the deal they negotiated, with risk of disproportionate liability if they fail to work out what a court will say.

- **One-sided jurisdiction clauses** sometimes suspect, as in France. So you end up in the wrong court which very different conflicts of law rules. In England, you don't have to get involved in arbitration and court exclusivity fall-backs.

- **Zero hour rule**, ie bankruptcy order backdated to midnight so that intervening transactions can be void.

- Much tougher insolvency **claw-backs** (preferences) so less finality. See international survey in chapter 24 of vol 1 of my 2019 books.

- **IMF Article VIII 2b**: a sovereign debtor can unilaterally impose a moratorium and change the deal, effective in IMF member states, except the few, such as England, which do not apply the article to loans, bonds, etc. France, Germany and Luxembourg do apply the article to these situations so a choice of their law enables the country to change financial contracts (its own and those of its corporates) by passing an exchange control – which insolvent states almost always do. See vol 8 of my 2-19 books, chapter 9, pp 99 ff.

- Unclear on **recharacterisation of repos and other title finance.** So asset finance could be void, a disproportionate penalty. English law does not recharacterize in the normal case. See international examples in chapter 48 of vol 3 of my 2019 books.

- **Non-assignment clauses in contracts widely voided**. Assignments can destroy mutuality necessary for set-off and involve inaccessible rules about netting against assignees. There are many other reasons why contracting parties want to know their counterparty, including privacy, IP protection, trusted party in a project, and embargoes/sanctions. UK version applies to SMEs only and excludes finance contracts. See international examples in chapter 17 of vol 3 of my 2019 books.

- **Judgement recognition under Brussels** seems a non-point in wholesale markets. English money judgments have one of the best recognition records in the world and you don't need a treaty. The UK also has one of the widest networks of reciprocal enforcement treaties in the world. Most countries in the EU (and elsewhere) routinely recognize proper foreign money judgments without a treaty: you don't have to a member of the EU to have your judgment recognized and enforced in most commercial countries and the basic conditions are usually easy to satisfy. Foreign enforcement in respect of corporations who don't pay are typically overtaken by insolvency standstills, so the occasion for enforcement is rare. New York judgements have poor foreign recognition because of the litigation system, but markets are not bothered. The situation was extensively corroborated in the 1980s and 1990s by international surveys by the IBA and others. World survey in chapter 23 of vol 8 of my 2019 books.

- Unclear or weak on policy to **uphold bargains**, e.g. anti-deprivation rule in joint venture forfeiture clauses and securitisations, post-commencement subordinated turnover proceeds, and post-commencement collateral. In all of these cases, a pre-agreed transfer of assets after a petition for an insolvency may be void with serious adverse effects on the deal. Particularly troublesome for turnover subordinations if the junior creditor is insolvent.

- **Language -** affects accessibility of legal rules and also problems of litigation in a foreign language if there is a dispute. A major practical problem if it happens. I expect there are other litigation points.

- Weakness of **doctrine of precedent**, so less predictable.

- **Less case law on the issues,** so again less predictability. Because of the role of the English courts internationally, there is ample case law on the major issues and the major documents, thereby enhancing predictability.

- **Financial judiciary not centralised** and so less consensus on the legal policies. English case law shows a distinctive adherence to the chosen policy in this area of law.

- **Judges** often go straight from student academia or a bureaucratic government post to the bench without practitioner experience. Most of the English judiciary is drawn from practitioners who have had extensive exposure to the realities of markets and therefore a different set of attitudes compared to the academic approach. They are also knowledgeable about market practice. I can say these things because I have been both an academic and a practitioner.

- Lack of familiarity of the legal system hampers **market acceptability** of a deal. So it is less easy for arrangers to market the deal. Markets cannot assess an unusual governing law which has to have a strong goodwill brand based on historical record. English law is extremely familiar to international markets and trusted. This is a major factor in practice.

- Tough **director duties to file** and stop trading. Hampers work-outs. The English rule catches only obviously irresponsible behaviour and there is no absolute duty to file when the company is insolvent. Sometimes banks are liable for **abusive credi**t, ie it is the lender's fault, which further interferes with a work-out. Unknown to English law.

The choice of governing law was intensely debated in the 1970s with the advent of international financial markets based in London in the late 1960s after detailed research, which included civil law systems in Europe. The result was that international banks generally preferred international loan agreements and bond issues to be governed by English or New York law. International banks refused to lend to sovereign borrowers who requested arbitration. The question arose again in the Greek bankruptcy and again because of Brexit. It is considered that Brexit does not affect the conclusions above since Brexit is mainly concerned with constitutional issues, trade and immigration, not private law issues. Ironically in some respects Brexit improves the ability of England to shield its private law system from adverse measures in the EU challenging some central precepts of the English legal ideology, eg as regards the law of contract and insolvency law.

The historical reasons for the above divergences seem to include the timing of the industrial revolution in relation to the timing of the 19th century crystallisation of legal systems, i.e. agricultural versus corporate and financial societies, and various local factors such as the historical role played by academics unsympathetic to trade and finance in the formation of the codes, as opposed to practitioners. That is the force of history for you. The relative permanence of laws does not necessarily reflect the evanescent culture of the swiftly passing days so that the present culture of a country may not sync with its apparent culture shown by its laws.

I have written articles on these matters in, for example, Business Law International, Capital Markets Law Journal 2020 vol 15, no 1, pp 3-16, and Butterworths Journal of International Banking and Financial Law. See the discussion of ten key points in chapter 3 of vol 8 of my 2019 books. Many of the points were illustrated in colours in my *Maps of World Financial Law* (2008) so that you could get a quick general impression at a glance without having to wade through vast tomes.

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