Swiss ease recovery of securities on the bankruptcy of custodians

In theory, depositors of securities with a custodian have always been able to reclaim them if the custodian goes bankrupt. But this theory has never been tested in the courts. New legislation removes any doubt. By Urs Schenker of Baker & McKenzie, Zurich

According to Swiss legal writing, securities deposited with a custodian are normally recoverable in the event of the custodian's bankruptcy on the basis of the depositors' continued ownership or co-ownership of the securities. No case of this sort has yet come to court, so there has always been some insecurity on the matter.

Doubts have now been allayed by an amendment of the Banking Act which entered into force on January 1 1997. The amendment allows bank customers to recover not only securities deposited with the bank, but also securities in which the bank has acquired an ownership interest on a fiduciary basis. However, cash deposited with a bank or an equivalent financial institution, cannot be recovered in the event of the recipient's bankruptcy, where the investor has only an unprivileged claim against the estate in bankruptcy.

Recovery based on ownership and co-ownership

Investors in Switzerland usually deposit their securities with banks or security dealers acting as custodians. The existing Federal Act on Collection Procedure and Bankruptcy (Bankruptcy Act) does not contain any special provisions on the recovery of deposited securities in case of a custodian's bankruptcy.

When the Bankruptcy Act was enacted, provisions were judged unnecessary because securities were largely deposited in individual deposits. In this case the investor's securities were stored in the custodian's facilities, but were physically segregated from the securities of other customers and from the custodian's own securities. The depositor remained the owner of the securities because, under a contract of deposit, no ownership interests passed to the custodian. If the custodian went bankrupt, the investor, therefore, could recover any securities he could identify as deposited by him. Because the individual deposit is labour-intensive it is now only used for securities which are not traded.

Most securities are held in collective deposits. The custodian holds its own securities and its customers' securities collectively, either in the custodian's facilities or in a central securities depository. The terms and conditions applicable to custody accounts usually stipulate that owners of securities held in collective deposits are co-owners of these collective deposits, based on the proportion of their securities holdings to the total holdings deposited in the collective deposit. This would avoid the risk that, by mingling the clients' securities with its own, the custodian becomes the sole owner of all securities. On the basis of co-ownership the investor can recover the securities held in collective deposit.

To facilitate the deposit securities, two central securities depositories exist: Sega and Intersettle accept deposits by banks and other custodians of interchangeable securities (ie securities identical except for their individual securities number). All securities delivered by a custodian to Sega or Intersettle are safeguarded in the name of the custodian, although both institutions are aware all or part of the securities submitted in this way are held by the custodian for its customers.

> **Under Article 37b, deposits of securities are not part of the estate in the case of bankruptcy of a bank, but will be segregated for the benefit of the deposit customers**

To make the concept of co-ownership, developed for custodians' internal collective securities deposits, applicable to central securities depositories, and to provide the custodian's customers with the means to recover their securities in the event of the bankruptcy of Sega, Intersettle or the custodian itself, Sega and Intersettle in their general terms and conditions, explicitly recognize the co-ownership of the custodian's customers with regard to securities placed with them.

So far, the co-ownership concept has always been respected in case of a custodian's bankruptcy or liquidation. However, it remains only a concept because it has never been challenged in court, and there is still no practical precedent to confirm it.

New provisions of the Banking Act

The Bankruptcy Act was revised on January 1 1997, bringing with it two new provisions to the Banking Act (Article 37b and Article 16) intended to clarify the recovery of securities deposited with banks. Under Article 37b, deposits of securities are not part of the estate in the case of bankruptcy of a bank, but will be segregated for the benefit of the deposit customers. Article 16 defines deposits as:

- movables and securities of deposit customers;

- movables, securities and claims which the bank holds on a fiduciary basis for the account of deposit customers; and
- claims of the bank against third parties stemming from cash transactions, expired future contracts and covering transactions or new issues purchased for the account of a deposit customer.

Neither the Bankruptcy Act nor the Banking Act provide for the recovery of a cash deposit with a Swiss bank or another financial institution. The investor only has a claim on the restitution of the same amount against the recipient

A bank customer, therefore, may recover:

- securities it has deposited with the bank under a normal deposit arrangement (regardless of whether the deposit was an individual or a collective deposit);
- securities in which the ownership interest has been transferred to the bank on the basis of a fiduciary arrangement (in particular, with shares registered not in the customer's but in the bank's name); and
- securities which the customer has purchased from a third party through the bank, which have not yet been delivered to the bank at the time the bank is designated bankrupt.

Under Article 37b, it will be assumed that deposits made by a bank with a third party are owned by the banks' deposit customers and are also to be segregated in favour of those customers in case of the bank's bankruptcy.

As far as banks act as custodians the Banking Act enables customers to recover any deposited securities without referring to the concept of co-ownership. It must, however, be stressed that the Banking Act applies only to banks which hold a licence under the Banking Act. They do not apply to other custodians such as security dealers or central depositories. As far as these custodians or sub-custodians are concerned, investors have to fully rely on the co-ownership concept described above.

Article 37 of the Banking Act, and the concept of co-ownership, apply only if the securities concerned are still held by the custodian or a sub-custodian. If the custodian has sold these securities in violation of his obligations, the investor is not protected by any deposit insurance. This kind of insurance concept is unknown in Switzerland. Based on the co-ownership concept, the investor can only recover securities from the third party to which they have been transferred if it can be shown that the third party acted in bad faith; in the knowledge it should have known the securities concerned were deposited, and not owned by the custodian.

No recovery of cash deposits

Neither the Bankruptcy Act nor the Banking Act provide for the recovery of a cash deposit with a Swiss bank or another financial institution. A cash deposit is either made in the form of a contract of deposit or a full loan agreement. In both cases, the recipient of the cash becomes owner of all the deposited funds, and the investor only has a claim on the restitution of the same amount against the recipient.

Therefore, in the event of the recipient's bankruptcy, deposited funds fall into the bankrupt's estate, the depositor having only a claim against the estate. This claim is not privileged and, therefore, will be paid only after all the privileged claims have been satisfied in full. Of all cash deposits only bank accounts in which individual persons regularly receive salary payments or similar payments, and saving accounts enjoy a privileged status in the event of the bankruptcy of a bank. The privilege, however, is limited to Sfr30,000 (US$20,000) per account. There is no deposit insurance which would indemnify the depositor of cash in case of the banks' or the financial institutions' bankruptcy. ❑