IS IT „SECURE" TO USE A SECURITY TRUSTEE IN BULGARIA?

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1. The Concepts of "Trust" and "Security Trustee"

It would be difficult to identify a universally accepted definition of "trust" and "security trustee" although these legal concepts appear to be well-developed in common law systems and are also acknowledged in a few civil law jurisdictions. Probably one of the most recognized and internationally supported definition of "trust" is provided by the Convention on the Law Applicable to Trusts and on their Recognition (the **"Trusts Convention"**)[1]. It refers to the term "trust" as "the legal relationships created - *inter vivos* or on death - by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose".

A trust is often used to save time and costs when creating security in finance deals. In such cases a security trustee is appointed to hold and manage the collateral under the finance transaction in its own name but for the benefit of a syndicate of creditors (i.e. to establish and perfect the collateral, to ensure its prompt maintenance, to undertake foreclosure in the event of default, etc.).

The "trust" relationships and the role of a security trustee are not expressly regulated by Bulgarian law[2]. Further, Bulgaria is not a party to the Trusts Convention.

This lack of legal regulation poses important practical questions related to the use of a security trustee in finance transactions where Bulgarian law is relevant, which shall be briefly addressed below.

2. Security Trustee in Local Transactions

In general

In local financing where all elements of the transaction are related exclusively to the Bulgarian jurisdiction (e.g. the lenders and the debtor are local entities, the assets used as collateral are located and/or registered in Bulgaria, etc.), Bulgarian law usually governs all credit and security documents. According to Bulgarian conflict-of-law provisions in these cases the choice of a foreign law to govern the transaction would be possible but nevertheless all mandatory rules of the Bulgarian law would still be applicable. This rule makes the choice of a foreign governing law in such situations impractical.

In view of the above may a group of local creditors appoint a security trustee to hold the collateral in trust for their benefit? If so, are there any legal risks in using this structure and is it possible that such risks can be sufficiently minimized?

Bulgarian law security interests

[1] Concluded on 1 July 1985.

[2] That is aside from certain perfunctory acknowledgements and references to the existence of "trust" in the tax legislation, in capital markets legislation and arguably in the law regulating financial collateral arrangements. For example, under the effective Public Offering of Securities Act *"collective investment undertaking other than the closed end type"* is defined to be "an investment undertaking or unit **trust** ...."

The most commonly used types of Bulgarian law security interests are the mortgage and the pledge. In short:

- A mortgage is a security interest in a real estate or a ship granted by its owner ("mortgagor") in favour of a mortgagee as a security for a debt. The mortgage takes effect upon registration in a public register and the possession of the property remains with the mortgagor.
- A pledge is a security interest traditionally established over movables and receivables, as the valid creation of a pledge over a movable requires the delivery of the possession of the asset to the pledgee or a person nominated by the pledgor and the pledgee ("possessory pledge").

In addition as of 1997[3] registered (non-possessory) pledges may also be established over movables (with the exception of aircraft and ships), receivables, aggregations of assets, securities, equity shares, industrial property rights and going concerns. The perfection of these pledges is effected by registration in a public register/s. As opposed to the traditional (possessory) pledges the setting up of a registered pledge does not require delivery of the possession of the asset to the creditor. Moreover, the pledgor may be entitled to dispose of the pledged assets in the normal course of business until foreclosure procedure is started.

The importance and use of the financial collateral[4] - financial pledge or collateral assignment also seems to be increasing in Bulgaria in recent years.

A financial pledge is an arrangement where the collateral taker obtains a security interest in the relevant financial collateral (e.g. a monetary claim, shares, bonds, options, etc.), where the title in the collateral remains with the collateral provider.

Collateral assignment involves title transfer of financial collateral to the collateral taker on the basis that it or equivalent assets will be transferred back if and when the secured debts are discharged.

Parties to the financial collateral arrangements may be certain entities which are exhaustively listed in the law, (such as public bodies, banks, insurance undertakings, investment brokers, financial institutions, etc.).

In all cases upon foreclosure the holder of the respective security interest holds a statutory determined priority for the satisfaction of the secured claims.

Can a security trustee validly hold collateral in local financings?

Generally under Bulgarian law a mortgage and pledge are considered accessory to the secured claim, (i.e. following its "destiny"). In particular, as per an express statutory rule[5] the pledge and the mortgage follow the secured claim upon its assignment and are considered cancelled should the secured claim be extinguished. Furthermore the effective statutory rules applying to a pledge and mortgage use the term "creditor" and "pledgee/mortgagee" as interchangeable.

[3] When the Special Pledges Act was enforced.
[4] The Bulgarian statutory act on financial collateral closely follows the Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, as amended.
[5] Article 150 of the Obligations and Contracts Act.

Due to the above specifics of the effective legal framework some legal practitioners in Bulgaria take the view that a security interest governed by Bulgarian law is valid **only if** the person receiving the security is at the same time the creditor. If such a view is accepted, this would mean that a Bulgarian law security interest may only be validly granted separately to each creditor, but not to a security trustee who is not the creditor of the secured claims[6].

The above legal conclusions are, however, not indisputable. Bulgarian law regulates various types of mandate relations[7]. For example the Commerce Act regulates the commission agreement as a type of a commercial transaction. In brief the relevant statutory rules provide:

- under a commission agreement the commission agent shall undertake, for a commission, to perform in its own name but on behalf of the principal one or more transactions;
- the agent must provide an account of its acts to the principal and transfer to the principal the results from the transactions concluded with third parties in performance of the mandate;
- under a transaction concluded with a third party for performance of the mandate, rights and obligations shall arise for the commission agent. Though in the internal relationship between agent and principal, these rights shall be deemed rights of the principal. Furthermore, the rights acquired by the agent or granted thereto by the principal shall be deemed, with respect to the agent's creditors, rights of the principal even before their transfer to the principal;
- the principal may exercise the rights and may be compelled to meet the obligations vis-à-vis a third party only after their transfer by the agent to the principal.

The Trusts Convention rightly qualifies "trust" as a "unique legal institution". No doubt that at present there is no arrangement under Bulgarian law which is identical to "trust". Regardless of this, it seems that in the context of mandate regulations, on a contractual basis an agent should be able to validly hold a security interest in /its own name on behalf of a creditor or on behalf of a number of creditors. This would not be inconsistent with the accessory nature of the Bulgarian law collateral, as the creditors shall be considered holders of the collateral both vis-à-vis the agent and the agent's creditors even without a formal transfer of the security interest to the creditor(s).

As to the wording of Bulgarian law implying that the creditor and pledgee/mortgagee should be one and the same person – it must be construed more as a reflection of the typical situation in the Bulgarian financial market at the time the relevant legislation was enacted (i.e. in 1951), rather than as mandatory statutory requirement. A more recent Bulgarian law - the Financial Collateral Arrangements Act, which is in force as of August 2006, expressly acknowledges that financial collateral could be granted to a merchant, which acts on behalf of one or more persons, that includes bondholders or holders of other forms of securitised debt or any of the other regulated institutions expressly listed in the law as possible collateral takers (such as banks, financial institutions, etc.).[8]

Despite the above strong legal arguments supporting the use of a security trustee in local transactions, the risks of successful challenges of the validity of Bulgarian law collateral being held by a security trustee still does exist.

May a parallel debt clause minimize the above risks?

[6] or least of all not the creditor of all the secured claims.
[7] Articles 280 – 292 of the Obligations and Contracts Act (mandate contract); Articles 32 – 42 of the Commerce Act (commercial agency); Articles 348-360 (commission agreement), etc.
[8] Article 3, paragraph 1, item 16.

A possible way to minimize risks referred to above could be the creation of a parallel debt in favor of the security trustee equivalent to the secured claims of the lenders/other creditors. Thus collateral held by the security trustee could secure also the parallel debt i.e. the collateral taker shall be deemed also to be the creditor. The borrower in this case will not be required to pay twice because any payment under the lenders' claims will be deemed payment also under the parallel debt and vice-versa.

As mentioned above, in local transactions parallel debt arrangements would have to be governed by Bulgarian law (or at the very least by all of its mandatory rules). Bulgarian law requires the transactions to have a *cause* in order to be valid i.e. to have a direct legitimate purpose (e.g. to credit, donate, etc). Cause is presumed to be in place unless proved otherwise.

It could be maintained that the cause of a parallel debt arrangement is to ensure valid security to the benefit of a changing group of creditors and thus argue that parallel debt is valid.

From a strict legal point of view the above interpretation certainly has its merits. However, parallel debt clauses are not sufficiently tested in practice in Bulgaria yet. Hence attempts to challenge the validity of Bulgarian law governed parallel debt on the basis of absence of "cause" (and thus the collateral securing it) could not be excluded.

Practical approach

Considering the existing legal uncertainties connected with a possible involvement of a security trustee in local transactions – when Bulgarian law governs all transaction documents (loan, security agreements, etc.) the security interests are usually held directly by all lenders but not by a security trustee.

For the time being the above conservative approach by local creditors seems to be justified. However, given the above mentioned provisions of the new Financial Collateral Arrangements Act using a security trustee to take financial collateral should not be too risky.

In any event there will be no obstacle for an agent as a direct representative of each of the lenders, to be authorized to administer the collateral in their name.

3. Security Trustee in Cross-Border Transactions

In general

Financing arrangements with an international component have been quite common for Bulgaria during the last two decades. Such arrangements are usually governed by a foreign law.

The choice of a foreign law to govern a cross-border transaction is a valid choice of law according to the Bulgarian conflict-of-law rules. Such choice will not prevent the application of the overriding mandatory rules of the Bulgarian law (such as e.g. regulatory, antitrust, tax provisions, etc.).

Furthermore, the provisions of foreign law will not be applied where the results of their application are deemed to be contrary to Bulgarian public policy.

Can a security trustee validly hold security interests in cross-border financing?

- *Security interests governed by a foreign law*

The use of a security trustee is not itself contradictory to Bulgarian public policy or in conflict with Bulgarian overriding mandatory rules. Thus, if a foreign law governs the security interests, a security trustee may validly hold such interests in trust to the extent the governing law permits, i.e. should such security interests be valid under the governing foreign law – generally a Bulgarian court should recognize them.

- *Security interests governed by the Bulgarian law*

There are situations where the master credit and security documents are governed by a foreign law (e.g. the laws of the State of New York, the laws of England, etc.) but a security interest is to be created and perfected as per the Bulgarian law. In this case the foreign law transaction documents often require a trustee acting in its own name but to the benefit of a syndicate of lenders and/or other secured parties to set up and hold the collateral under the transaction.

Considering the specific Bulgarian law concepts discussed above (as e.g. the accessory nature of the mortgage and pledge, etc.) the validity of the Bulgarian law collateral when taken by a security trustee might again be subject to challenges (see Section 2, third subsection above). In the absence of relevant court practice the outcome of such potential challenges is not easily predicted.

May a parallel debt clause reduce the risks of the above challenges?

The answer to this question is definitely positive in case the parallel debt is governed by a foreign law and such law recognizes the validity of parallel debt clauses. In this case the Bulgarian law concept of the need for "cause" of the transaction would not be applicable and generally the parallel debt structure should be recognized by the local courts. (Of course the validity of such arrangements needs to be assessed on a case-by-case basis since the application of the specific contractual terms should not be in contradiction to Bulgarian public policy).

On the other hand parallel debt governed by Bulgarian law would again involve higher risks for the secured parties (see Section 2, fourth subsection above).

Practical approach

In cross-border transactions with a Bulgarian component security interests are often created and perfected in Bulgaria with the participation of a security trustee. The security trustee itself is typically organized under a foreign law, which is the recommended approach as no "trust' laws are enforced in Bulgaria.

Should the Bulgarian law govern a security interest (e.g. a pledge over an aircraft with Bulgarian registration, etc.) often a parallel debt in favor of the security trustee is agreed. Thus, the collateral held by the trustee secures the parallel debt or possibly both the claims of the lenders (other secured parties) and the parallel debt[9]. The parallel debt is again governed by an appropriate foreign law.

The use of a parallel debt structure governed by a foreign law seems to be dependable as it substantially reduces the risks for the secured creditors to lose the local collateral.

In the case where this is a viable option (e.g. because the number of the creditors is limited) and/or where the core collateral is to be set up under Bulgarian law, foreign lenders may also decide to become direct parties to the Bulgarian law security documents and thus ensure maximum protection for their interests.

[9] In the last case the lenders could rely not only on the parallel debt clause but also on the Bulgarian law mandate regulations in order to defend the validity of the local collateral.

Conclusion

On cross-border financings collateral in the name of a security trustee have been set up and successfully perfected in Bulgaria. However considering certain traditional local concepts, rightly or not, secured creditors using a security trustee could be exposed to certain practical risks. There are contractual mechanisms to minimize these risks (e.g. the use of parallel debt clause governed by foreign law) but probably the best way to fully exclude such risks would be if Bulgarian law is amended in the future to expressly recognize the role of the security trustee.

Bulgaria joining Trusts Convention would certainly also be a step in the right direction, and a step to be encouraged by both business players and legal practitioners.

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