

PART D

SECURED TRANSACTIONS, EQUIPMENT FINANCE, AND GUARANTEES

Chapter 15 is concerned with secured transactions as understood under English law. It also examines certain matters that are similar to or associated with such transactions. After an introduction dealing with matters that are relevant in a general sense to secured transactions, it then moves to consider concepts of property, interests in property and dealings therein, future property and attachment of proprietary interests, accretions to and the proceeds of assets, the forms of security, floating charges, security in financial assets, security over intellectual property, security over credit balances, rights of set-off, *Quistclose* trusts, registration requirements for corporate security, priorities, subordination of unsecured debt, upsetting prior transactions, and enforcement of security.

Chapter 16 is concerned with equipment finance, sometimes called title finance. It examines the methods by which a financier might acquire title in equipment, the forms of transaction by which equipment is made available by the financier to its customer, the financier's statutory responsibilities for the equipment and the effectiveness of attempts to exclude or restrict that responsibility, the rights and obligations of the parties following a default by the customer, the effect of the customer's insolvency, the financier's rights against third parties, and insurance arrangements.

Chapter 17 concerns guarantees. It looks at the nature of a guarantee as contrasted with other types of instrument, preliminary matters in taking a guarantee, State guarantees under EC law, the types of guarantee, Export Credits Guarantee Department (ECGD) cover, the rights of the guarantor, reasons for the discharge of the guarantor, and provisions to save the beneficiary's position under the guarantee.

Chapter 18 relates to the case for reform of secured transactions under English law. It discusses the reasons why reform is needed and then reviews proposals that were put forward by the Law Commission to effect reform of the law.

SECURED TRANSACTIONS

14.1	Introduction and Preliminary Matters	14.1
14.1.1	The nature of security	14.1.1.1–14.1.1.2
14.1.2	The equitable right to redeem	14.1.2.1
14.1.3	The reasons for taking security	14.1.3.1–14.1.3.4
14.1.4	The liabilities that may be covered by security	14.1.4.1–14.1.4.3
14.1.5	Non-recourse security	14.1.5
	14.1.5.1 Other methods of non-recourse financing	14.1.5.1.1–14.1.5.1.3
14.1.6	Third party security	14.1.6
14.1.7	Security held by a trustee	14.1.7
14.1.8	Intention to create security	14.1.8.1
14.1.9	Contractual impediments to the creation of security	14.1.9
	14.1.9.1 Negative pledges	14.1.9.1.1–14.1.9.1.2
	14.1.9.2 Restrictions within a contract upon dealing with rights arising under the contract	14.1.9.2.1–14.1.9.2.2
	14.1.9.3 Other types of restriction	14.1.9.3
14.1.10	Conflict of laws and cross-border issues	14.1.10.1
14.2	Concepts of Property, Interests in Property, and Dealings in Property: An Introduction	14.2.1
14.2.2	Concepts of property	14.2.2.1
14.2.3	Legal and equitable interests in assets	14.2.3
	14.2.3.1 Legal interests	14.2.3.1.1–14.2.3.1.4
	14.2.3.2 Equitable interests	14.2.3.2.1–14.2.3.2.7
14.3	The Concepts of Future Property and Attachment	14.3.1
14.3.2	Future property	14.3.2.1–14.3.2.4
14.3.3	Attachment	14.3.3.1–14.3.3.2
	14.3.3.3 Goods	14.3.3.3.1–14.3.3.3.2
	14.3.3.4 Intangible property	14.3.3.4
14.3.4	Security bills of sale	14.3.4
14.3.5	Static and transient assets	14.3.5
14.4	An Asset, Fruits of and Substitutions for the Asset, and the Proceeds of Sale of the Asset	14.4.1
14.4.2	Fruits and substitutions	14.4.2
14.4.3	Proceeds of sale of an asset	14.4.3
14.5	Forms of Security	14.5.1
14.5.2	Possessory security	14.5.2
	14.5.2.1 Pledges	14.5.2.1.1–14.5.2.1.2
	14.5.2.2 Contractual liens	14.5.2.2
14.5.3	Non-possessory security	14.5.3
	14.5.3.1 Legal mortgage	14.5.3.1.1–14.5.3.1.4
	14.5.3.2 Equitable mortgage	14.5.3.2.1–14.5.3.2.4
	14.5.3.3 Equitable lien	14.5.3.3.1–14.5.3.3.2
	14.5.3.4 Equitable charge	14.5.3.4.1–14.5.3.4.2
	14.5.3.5 Debenture	14.5.3.5
14.6	Floating Charges	14.6
14.6.1	Introduction	14.6.1.1–14.6.1.4

14.6.2	The importance of the distinction between fixed security and floating charges	14.6.2
14.6.2.1	Advantages	14.6.2.1.1
14.6.2.2	Disadvantages	14.6.2.2.1–14.6.2.2.4
14.6.3	The nature of a floating charge	14.6.3.1–14.6.3.4
14.6.4	The essential characteristic of a floating charge	14.6.4.1–14.6.4.2
14.6.5	The liberty to deal	14.6.5.1–14.6.5.2
14.6.6	Fixed v floating security in the context of particular transactions	14.6.6.1
14.6.6.2	Book debts (receivables)	14.6.6.2.1–14.6.6.2.6
14.6.6.3	Other assets	14.6.6.3
14.6.6.4	Plant and equipment	14.6.6.4
14.6.6.5	Equipment leases or hire purchase transactions and rental payable under them	14.6.6.5.1–14.6.6.5.2
14.6.6.6	Insurance policies	14.6.6.6
14.6.6.7	Shares in a company	14.6.6.7.1–14.6.6.7.3
14.6.6.8	Contractual rights	14.6.6.8
14.6.6.9	Intellectual property	14.6.6.9.1
14.6.6.10	Real property	14.6.6.10.1–14.6.6.10.2
14.6.7	Crystallisation	14.6.7
14.6.7.1	The circumstances in which crystallisation may occur	14.6.7.1.1–14.6.7.1.3
14.6.8	Priorities	14.6.8.1
14.6.8.2	Transactions that take place before crystallisation	14.6.8.2.1–14.6.8.2.4
14.6.8.3	Transactions that take place after crystallisation	14.6.8.3.1–14.6.8.3.3
14.6.8.4	Statutory priorities	14.6.8.4.1–14.6.8.4.2
14.7	Taking Security Over Shares and Other Financial Securities	14.7.1–14.7.1.3
14.7.2	Equitable interests in shares	14.7.2
14.7.3	Certificated securities and physical instruments	14.7.3.1–14.7.3.2
14.7.4	Uncertificated securities	14.7.4
14.7.4.1	The CREST system	14.7.4.1.1–14.7.4.1.4
14.7.5	Intermediated Securities	14.7.5.1 The legal analysis of intermediated securities
14.7.6	The Financial Collateral Arrangements (No 2) Regulations 2003	14.7.6
14.7.6.1	Definitions	14.7.6.1.1–14.7.6.1.4
14.7.6.2	Modifications to formal and registration requirements under English law	14.7.6.2
14.7.6.3	Modifications to English insolvency law	14.7.6.3
14.7.6.4	The right to use	14.7.6.4.1–14.7.6.4.2
14.8	Taking Security over Intellectual Property	14.8.1–14.8.1.5
14.8.2	Taking security over statutory IP rights in the UK	14.8.2
14.8.2.1	Registered rights	14.8.2.1
14.8.2.2	Unregistered rights	14.8.2.2
14.8.3	Companies Act registration	14.8.3
14.9	Taking Security over Receivables	14.9.1–14.9.2

14.10	Taking Security over Credit Balances and Other Obligations Owed by a Creditor	14.10.1–14.10.1.1
14.10.2	The reasons for preferring security to set off	14.10.2.1
14.10.3	The conceptual impossibility argument	14.10.3.1–14.10.3.4
14.10.4	Insolvency set-off relating to the deposit taking by the bank	14.10.4.1–14.10.4.2
14.10.5	‘Flawed asset’ provisions	14.10.5.1–14.10.5.3
14.11	Set-off	14.11.1–14.11.1.1
14.11.2	Pre-insolvency set-off	14.11.2
14.11.2.1	Legal set-off	14.11.2.1.1
14.11.2.2	Equitable set-off	14.11.2.2.1.1–14.11.2.2.4
14.11.2.3	Contractual set-off	14.11.2.3.1–14.11.2.3.3
14.11.2.4	The banker’s right of set-off	14.11.2.4.1–14.11.2.4.3
14.11.2.5	Precluding the exercise of rights to set-off	14.11.2.5.1–14.11.2.5.4.1
14.11.2.6	Negotiable instruments	14.11.2.6.1–14.11.2.6.3
14.11.3	Insolvency set-off	14.11.3.1–14.11.3.3
14.11.3.4	Set-off in bankruptcy	14.11.3.4.1–14.11.3.4.4
14.11.3.5	Set-off in a winding up	14.11.3.5.1–14.11.3.5.3
14.12	<i>Quistclose</i> Trusts	14.12
14.12.1	The <i>Quistclose</i> case	14.12.1.1–14.12.1.2
14.12.2	Other cases	14.12.2
14.12.3	The type of trust	14.12.3.1
14.12.4	The questionable need for protection	14.12.4
14.12.5	Sufficient intention or purpose	14.12.5
14.12.6	Acceptance of the principle	14.12.6
14.12.7	Judicial analysis of <i>Quistclose</i>	14.12.7
14.12.8	Money received when the recipient has stopped trading	14.12.8
14.13	Company Registration Requirements	14.13.1–14.13.1.1
14.13.2	Registrable charges	14.13.2.1–14.13.2.3
14.13.3	The process of registration	14.13.3.1–14.13.3.4
14.13.4	The consequences of a failure to register	14.13.4.1
14.13.5	Other entries on the register	14.13.5.1–14.13.5.2
14.13.6	Late registration	14.13.6.1–14.13.6.3
14.13.7	The power to make secondary legislation	14.13.7.1–14.13.7.2
14.13.8	Security given by a registered overseas company	14.13.8.1–14.13.8.3
14.13.9	Re-characterisation	14.13.9.1
14.14	Priorities	14.14.1–14.14.1.2
14.14.2	Some general principles	14.14.2
14.14.2.1	The role of notice	14.14.2.1
14.14.2.2	Purchaser for value of the legal estate	14.14.2.2.1–14.14.2.2.2
14.14.2.3	The <i>nemo dat</i> rule	14.14.2.3
14.14.2.4	Competing equitable interests	14.14.2.4.1–14.14.2.4.2
14.14.2.5	The purchase money security interest	14.14.2.5
14.14.2.6	Floating charges	14.14.2.6.1
14.14.2.7	Priority agreements	14.14.2.7
14.14.3	Goods	14.14.3.1–14.14.3.3
14.14.4	Debts	14.14.4

14.14.5	Further advances	14.14.5.1–14.14.5.2.5
14.15	Subordination	14.15
14.15.1	Introduction	14.15.1.1–14.15.1.5
14.15.2	Types of subordination arrangement	14.15.2.1
	14.15.2.2 Turnover subordination and subordination trusts	14.15.2.2
	14.15.2.3 Contingent debt subordination	14.15.2.3
	14.15.2.4 Situations outside the insolvency of the debtor	14.15.2.5
14.15.3	Legal issues that arise in connection with subordination	14.15.3
	14.15.3.1 <i>Pari passu</i> distribution in a winding up of the debtor	14.15.3.1.1
	14.15.3.2 Insolvency set-off as between the insolvent debtor and the junior creditor	14.15.3.2.1–14.15.3.2.3
	14.15.3.3 Participation of the junior creditor in the prescribed part of floating charge property	14.15.3.3
	14.15.3.4 Subordination trusts by way of security	14.15.3.4.1–14.15.3.4.3
	14.15.3.5 The <i>pari passu</i> principle in the insolvency of the junior creditor	14.15.3.5
	14.15.3.6 Disclaimer of a subordination arrangement as an unprofitable contract in the insolvency of the junior creditor	14.15.3.6.1–14.15.3.6.6
	14.15.3.7 Administration of the junior creditor	14.15.3.7
	14.15.3.8 The junior creditor as a surety	14.15.3.8.1
14.16	Upsetting Prior Transactions Entered into by an Obligor	14.16.1
14.16.2	Avoidance of dispositions of property in a compulsory winding up	14.16.2.1–14.16.2.4
14.16.3	Transactions at an undervalue	14.16.3.1–14.16.3.3
	14.16.3.4 Giving security	14.16.3.4.1–14.16.3.4.3
14.16.4	Preferences	14.16.4.1
	14.16.4.2 Relevant time	14.16.4.2
	14.16.4.3 A preference	14.16.4.3.1–14.16.4.3.3
	14.16.4.4 Influenced by a desire	14.16.4.4
14.16.5	Sections 238 and 239: remedies	14.16.5.1–14.16.5.2
	14.16.5.3 Third parties	14.16.5.3
	14.16.5.4 Secured parties	14.16.5.4.1–14.16.5.4.2
14.16.6	Transactions defrauding creditors	14.16.6.1
	14.16.6.2 Transaction at an undervalue	14.16.6.2
	14.16.6.3 Purpose	14.16.6.3.1
	14.16.6.4 Victims	14.16.6.4
14.16.7	Avoidance of floating charges	14.16.7
	14.16.7.1 Relevant time	14.16.7.1
	14.16.7.2 The invalidity	14.16.7.2
	14.16.7.3 Points arising	14.16.7.3.1–14.16.7.3.5
14.16.8	Extortionate credit transactions	14.16.8.1–14.16.8.2
14.17	Enforcement of Security	14.17
14.17.1	Determining whether to enforce and the position before enforcement	14.17.1.1–14.17.1.4
14.17.2	Foreclosure	14.17.2.1
14.17.3	Application of financial collateral	14.17.3

14.17.4	Application of cash balances	14.17.4.1
14.17.5	Taking possession	14.17.5.1
14.17.6	The power of sale	14.17.6
	14.17.6.1 Pledges	14.17.6.1
	14.17.6.2 Non-possessory security	14.17.6.2.1
	14.17.6.3 Duties in exercising the power of sale	14.17.6.3
	14.17.6.4. Mortgagee must not sell to itself	
14.17.7	Appointment of an administrator	14.17.7.1
14.17.8	Appointment of a receiver	14.17.8.1–14.17.8.3
	14.17.8.4 Receivers of specific assets	14.17.8.4.1
	14.17.8.5 Administrative receivers	14.17.8.5.1–14.17.8.5.2.4
	14.17.8.6 The duties of a receiver	14.17.8.6.1
14.17.9	Administrative Receivers	14.17.9.1
	14.17.9.2 Capital market arrangements (section 72B)	14.17.9.2
	14.17.9.3 Public–private partnerships (section 72C)	14.17.9.3.1–14.17.9.3.5.2
	14.17.9.4 Project finance (section 72E)	14.17.9.4.1–14.17.9.4.3

14.1 Introduction and Preliminary Matters

14.1.1 The nature of security

Taking security involves the concept that one or more assets (in American terminology called ‘collateral’) is set aside or appropriated by the security giver to provide a right or interest in that asset or assets in favour of a security taker to secure an obligation owed by the security taker or another person¹ In the event of a failure in the fulfillment of the underlying obligation for which the security has been taken, the creditor may have recourse to the asset, usually by selling it (there are other methods of enforcement or realisation of security that will also have to be discussed), so that the proceeds of the sale or other method of enforcement can be applied towards satisfying the unfulfilled obligation. It is said that the creditor, through taking its security, acquires a ‘proprietary’ interest in the asset, that is, a right *in rem* in the asset. Under English law the same asset may serve as security in favour of more than one creditor. Each such creditor may hold separate security from the obligor over the asset or the security may be held for them jointly, through a trustee acting on their behalf.² In addition, security can be given to a person other than the creditor to whom the secured obligation is owed or a trustee for that person³. The security may be provided by either the obligor or a third party⁴.

14.1.1.1 The asset (or assets) concerned may have some direct correlation to the finance provided by the creditor, because the finance was used to fund its purchase (‘purchase money security’). Alternatively, the security may be more remote, in the

¹ In this chapter, the expression ‘creditor’ or ‘security taker’ will be used to refer to the party that takes the benefit of security and the expression ‘obligor’ or ‘security giver’ will be used to describe the party that provides the security (even though, in some cases, the security giver may not be the obligor).

² For a recent example of the use of a security trustee, see *Saltri Iii Ltd v MD Mezzanine Sa Sicar* [2012] EWHC 3025 (Comm.)

³ *Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch), [2014] BCC 295.

⁴ *Re Conley* [1938] 2 All ER 127

sense that the asset is made available as security for liabilities which were not directly associated with the finance provided for the acquisition of that particular asset. The distinction usually does not matter in English law, although it might be relevant to a priority race, as will be discussed at a later point in this chapter.

14.1.1.2 In terms of the assets which may form the subject matter of security, this chapter is concerned, by and large, with tangible personal property (e.g. goods) and intangible assets. Because of its entirely domestic nature under English law, the chapter will not be concerned with taking security over English real property, although much of the discussion is also relevant in the context of security over real property.

14.1.1.3 It is useful to note at this stage that English law does not contain the concept of a single type of security interest, akin to that found, for example under the Uniform Commercial Code in the USA or Personal Property Security Acts in Canadian provinces, New Zealand, Australia or Jersey although a law reform incorporating such a concept continues to be considered.⁵ Under the current English law of secured transactions there are four traditional forms of consensual security interests, namely pledge, contractual lien, mortgage and charge⁶, distinguished broadly speaking on the basis of which concept of property is employed to create them and how it is created. As a result of this differentiation, the rules that govern priority, parties' rights and duties, for example on enforcement, vary depending on the type of interest. In addition, while under English law it is also possible that some other proprietary interests in assets are used for the purposes of security, these are not considered as traditional forms of security and so different considerations follow. The details of the categorisation along with the various rights and duties of the parties as well as other rules applicable to each interest are discussed below.

14.1.2 The equitable right to redeem

It is inherent in the concept of security that an obligor has a right to redeem its security upon the payment or discharge of the liabilities covered by the security⁷, sometimes also referred to as 'an equity of redemption'.⁸ Subject to any agreement between the creditor and the obligor to the contrary, there is no equitable right to redeem in part only and the creditor is entitled to the whole of its security until it has been fully repaid.⁹ Subject again to any agreement to the contrary, the obligor must tender unconditional and irrevocable payment or discharge in redemption of the secured liabilities.¹⁰

⁵ See Chapter 17.

⁶ *Re Cosslett (Contractors) Ltd* [1998] Ch 495, 508.

⁷ As to the relationship between a contractual provision for redemption and the equitable right to redeem, especially in the context of contingent and future liabilities due to the mortgagee, see *Re Rudd and Son Ltd* (1986) 2 BCC 98,955 (CA) and *Law Debenture Trust Corp PLC v Concord Trust* [2007] EWHC 1380 (Ch).

⁸ The term 'an equitable right to redeem' is preferred here as it is free from the semantic burden carried by the phrase 'an equity of redemption'. The latter term is often understood in a more technical sense in relation to a mortgage to signify the mortgagor's residual equitable interest in the property after the mortgagee acquired title to it.

⁹ *Law Debenture Trust Corp PLC v Concord Trust* [2007] EWHC 1380 (Ch), at [53] (Lewison J), cited with approval in *Çukurova Finance International Ltd v Alfa Telecom Turkey Ltd (Nos 3 and 5)* [2013] UKPC 25, at [17] (Lord Mance JSC) and [79] (Lord Neuberger).

¹⁰ *Ibid.*

14.1.2.1 In equity, it is not permissible to prevent an obligor from redeeming its security; for instance, by providing that the security may never be redeemed and a provision which is intended to prevent that entitlement (called a ‘clog on the equity of redemption’) is void¹¹ although courts often have sought to mitigate its impact, treating it with some unease.¹² The parties may agree that the right of redemption should be postponed for the period of the relevant facility,¹³ provided that is not an unreasonably long period.¹⁴ The position has been changed by legislation in relation to companies, which can issue perpetual debentures, including by way of security.¹⁵

14.1.3 The reasons for taking security

The principal reason for taking security over an asset is to provide the creditor with protection against the consequences of a default by the obligor or another debtor whose liabilities are covered by the security. The security provides the creditor with a right of recourse to the asset or its proceeds of realisation so as to meet the relevant liabilities. Although enforcement rights may arise in other circumstances, this is particularly relevant in a situation where the obligor or other debtor has become insolvent, so that it is unable to meet its obligations to its general body of creditors. Except where legislation has intervened to reduce its rights,¹⁶ the creditor is able to stand outside the insolvency to the extent of its security and enforce that security for its own benefit. This is because the proprietary right of the creditor in the asset is paramount. The asset is treated as not forming part of the insolvent debtor’s assets that are available to meet the claims of its unsecured creditors, except to the extent that there is any value left over once the liability covered by the security has been discharged.¹⁷ Without the benefit of security, an ordinary creditor will find itself enmeshed in the mire of the insolvency, sharing with the other creditors on a *pari passu* basis in whichever of the debtor’s free assets are available to meet their claims (that is, assets which are not subject to security or held on trust for a third party¹⁸).

¹¹ *Noakes & Co Ltd v Rice* [1902] AC 24; *Kreglinger v New Patagonia Meat and Cold Storage Co Ltd* [1914] AC 25 (HL); *Jones v Morgan* [2001] EWCA Civ 995, [2002] 1 EGLR 125. *Jones v Morgan* [2001] EWCA Civ 995, [2002] 1 EGLR 125.

¹² See e.g. Earl of Halsbury LC in *Samuel v Jarrah* [1904] AC 323, at 325; *Jones v Morgan* [2001] EWCA Civ 995, [2002] 1 EGLR 125; see also *Warnborough Ltd v Garmite Ltd* [2003] EWCA Civ 1544, [2004] 1 P & CR DG8 and *Brighton & Hove CC v Audus* [2009] EWHC 340, [2010] 1 All ER (Comm) 343.

¹³ *Teevan v Smith* (1882) 20 Ch D 724; *Williams v Morgan* [1906] 1 Ch 804.

¹⁴ *Morgan v Jeffreys* [1910] 1 Ch 620.

¹⁵ S 739 of the Companies Act 2006, (previously s 193 of the Companies Act 1985). See *Knightsbridge Estates Trust Ltd v Byrne* [1940] AC 613.

¹⁶ Principally with respect to making recoveries under floating charges available for preferential creditors, unsecured creditors and the liquidator for his expenses, pursuant to ss, 40, 175 (2)(b), 176A, and 176ZA of the Insolvency Act 1986 and s 754 of the Companies Act 2006 (formerly s 196 Companies Act 1985). A floating charge holder also suffers certain disadvantages in an administration, such as under para 70 of Sched B1 to the Insolvency Act 1986, which entitles the administrator to dispose of assets subject to a floating charge. The holders of both fixed and floating security are subject to a moratorium on their rights of enforcement in an administration of a corporate obligor pursuant to paras 43 and 44 of Sched B1 to the Insolvency Act 1986. Similar restrictions apply where a proposal has been made for a company voluntary arrangement of an obligor which is an eligible company pursuant to para 12 of Sched A1 to the Insolvency Act 1986.

¹⁷ See the helpful summary provided by Lord Millett in *Buchler v Talbot* [2004] UKHL 9; [2004] 2 AC 298, at [51].

¹⁸ As noted by Rose LJ (on behalf of himself, Saville and Millett LJJ) in *Re Bank of Credit and Commerce International SA (No 8)* [1996] Ch 245, at 256. Although the decision was the subject of an appeal to the House of Lords (decided at [1998] AC 214), this particular point was not controversial.

The usual consequence is that very little is recovered by the unsecured creditors in satisfaction of what is owed to them.¹⁹

Table 14.1 The Order of Claims in an English Liquidation

1.	Ownership of Assets, Fixed Security Over Assets, and Liquidation Set-off Rights
	Ownership e.g.:
	Conditional sale and Retention of title
	Hire-purchase
	Equipment leases
	Receivables purchases
	<i>Quistclose</i> claims
	Fixed Security e.g.:
	Legal mortgages
	Equitable mortgages
	Fixed equitable charges
	Pledges
	Liens ²⁰
	Set-off in Winding up: Rules 2.85 and 4.90 Insolvency Rules 1986 (amended by SI 2005/527)
	<i>Note:</i>
	(i) Priority issues where there are competing claims
	(ii) Existing and future assets
2.	Expenses of the insolvency proceedings: section 115 of the Insolvency Act (expenses of both kinds of voluntary winding up, whether members' or creditors'); section 176ZA Insolvency Act 1986 (payment of expenses of winding up where property subject to a floating charge); section 156 of the Insolvency Act 1986 (winding up by court); paragraph 99 of Schedule B1 of the Insolvency Act 1986 (expenses of administration paid out of floating charge assets)
	<i>Note:</i> expenses are defined in rule 12.2 of the Insolvency Rules 1986. As to the priority order for payment of expenses in liquidation see rule 4.218 of the Insolvency Rules 1986. ²¹
3.	Preferential creditors: sections 175 ²² and 386 Insolvency Act 1986 i.e.: occupational pension scheme contributions, employees' remuneration, coal and steel contributions, debts owed to or deposits covered by the Financial Services Compensation Scheme or other deposits.
4.	The prescribed part of floating charge recoveries for the benefit of unsecured creditors: section 176A Insolvency Act 1986 ²³ .

¹⁹ As Lord Hoffmann explained in *Wight v Eckhardt Marine GmbH* [2003] UKPC 37; [2004] 1 AC 147, at [27], the liquidation of an insolvent company does not extinguish the debts due by an insolvent debtor to its creditors, but it has the practical effect that the creditors are confined in their remedies to lodging proofs of their claims against the debtor and receiving a *pari passu* dividend paid out of the available realised assets with respect to such claims.

²⁰ An exception is a lien or other right to retain possession of books, papers or other records of the company, which is unenforceable against the liquidator to the extent that its enforcement would deny the liquidator their possession under Insolvency Act 1986, s246(2). This does not apply to a lien on documents which give a title to property and are held as such under Insolvency Act 1986, s246(3).

²¹ As to the priority order for payment of expenses in administration see rule 2.67(1) of the Insolvency Rules 1986.

²² Applied in administration by paragraph 65(2) Schedule B1 of the Insolvency Act 1986.

-
5. Floating charges over assets
Note: Crystallisation of the charge may raise such a charge to Category 1 for some purposes, but not to defeat categories 2, 3 and 4
 6. Unsecured creditors with provable debts (other than preferential creditors and distribution of the prescribed part): rule 4.181 of the Insolvency Rules 1986.²⁴
Note: Possible ranking of certain unsecured creditors over subordinated creditors, otherwise rank equally. As to what constitutes a provable debt: rules 12.3 and 13.12 ('debt') of the Insolvency Rules 1986.²⁵
 7. Statutory interest on debts proved in a winding up: 189(2) of the Insolvency Act 1986²⁶
 8. Non-provable liabilities²⁷
 9. Shareholders
Note: Ranking of different types of shareholders
Note: The above assumes:
 - (i) the due registration of the security;
 - (ii) that the security is not vulnerable under the relevant provisions of the Insolvency Act 1986 (e.g.: ss 238, 239, 245, and 423);
 - (iii) that the security was given by a company.
-

14.1.3.1 Table 14.1 sets out the order of claims in an English winding up.²⁸ It serves to demonstrate the value to a creditor of holding security or rights which have a similar effect, as well as indicating the relative rankings of claims. It might also provide a useful source of comparative reference for the reader in the study of this chapter and of the various issues and entitlements that may arise when the dead arm of insolvency, particularly liquidation, intervenes.

14.1.3.2 Security endows the creditor with certain benefits even before debtor's default in the form of control of the course of events in some cases. For example, the creditor holding the floating charge in certain circumstances,²⁹ albeit quite narrow, may be able to appoint an administrative receiver to run the debtor's company. That aside, secured creditors generally have a degree of control if the prospect of enforcement of security is seen as a deterrent against the debtor engaging in a more risky behaviour. The secured creditor need not monitor the debtor's entire business every time but merely the asset in which security was taken. Another benefit in taking security is that it might give the creditor a priority right in the relevant asset which will rank ahead of, and may even defeat, the claim of another creditor in the same asset outside liquidation. When coupled with the ability to take enforcement without recourse to the courts, security provides the creditor with the ability to recover promptly and thus also relatively cheaply. More generally, the creditor with priority

²³ This section applies in both administration and liquidation.

²⁴ As to administration: rule 2.69 of the Insolvency Rules 1986.

²⁵ A creditor who has not proved a small debt (as prescribed by the rules) is taken as having proven the debt, para 13A in Schedule 8 of the Insolvency Act 1986, inserted by section 131 of the Small Business, Enterprise and Employment Act. A similar provision has been introduced in relation to bankruptcy.

²⁶ Rule 2.88(7) of the Insolvency Rules 1986 (administration).

²⁷ For example, claims in administration against a company for loss as a result of the conversion of debts from foreign currency into sterling at the start of the administration, see *Lehman Brothers International (Europe) (In Administration)* [2015] EWCA Civ 485, [2015] BCC 431.

²⁸ See Lord Neuberger in *Re Nortel Companies; Bloom v Pensions Regulator* [2013] UKSC 52, at [39]-[40]; *Lehman Brothers International (Europe) (In Administration)* [2015] EWCA Civ 485, [2015] BCC 431.

²⁹ See sections 72B – s72GA Insolvency Act 1986.

may be able to desist from having to take enforcement action to recover funds or other facilities that it has provided to the debtor, or at least defer its decision to do so. This, of course, will depend upon the secured creditor being confident as to the adequacy of its security and its continued right of priority. There are various circumstances in which this sense of adequacy may be lacking. One example is that the creditor might lose its claim to priority for further advances it makes once it has notice of another security over the same asset, pursuant to s 94 of the Law of Property Act 1925. Another is that the holder of a floating charge cannot be confident that it will prevail against the claims of third parties who acquire an interest in the charged assets.³⁰ Thus, an execution creditor will prevail against the interest of the holder of a floating charge, provided that the execution has been completed before the charge crystallises.³¹

14.1.3.3 In more general terms, the ability to provide security is of benefit to the prospective borrower as it may enable it to access finance which otherwise would be available: a creditor which is offered security may be willing to provide credit in circumstances where it might not be available on unsecured terms because the debtor is not considered to be a good risk. A creditor with security may also be more willing to continue providing credit to a debtor which finds itself in financial difficulties. Security is usually required to support financial rescues and work outs.³²

14.1.3.4 Holding security, as one type of credit risk mitigation technique, may also lead to regulatory benefits for the creditor, particularly if it is a bank. The security may entitle the bank to ascribe a lower risk weighting to an exposure than would be the case if the exposure was unsecured. This is explained further in Chapter 2.

14.1.4 The liabilities that may be covered by security

The liabilities that the security purports to cover will be determined as a matter of construction of the relevant security instrument or other agreement under which the security was created. Sometimes the security may only relate to a specific transaction or even, more concisely, to a particular debt that is due to the creditor. Once the relevant liability has been satisfied then the security will cease to be effective. The risk that arises in this respect is that, either by the debtor appropriating one or more particular payments against the secured liability³³ or by the application of *Clayton's* case,³⁴ the secured liability will be treated as having been discharged and the creditor

³⁰ The position as to floating charges is discussed further below.

³¹ *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979.

³² One of the criticisms of administration as a regime that should lead to the rehabilitation of businesses in the UK, is that there is no statutory mechanism by which the administrator can raise fresh funds to support the business, such as by granting security over the company's assets which would take priority over the rights of existing secured creditors under security granted before the administration commenced. This is unlike the position under Chapter 11 of the US Bankruptcy Code, where so-called 'super priority' security can be conferred on creditors which are willing to provide such funding to the company. A proposal to introduce such financing into English law (Insolvency Service, *Encouraging Corporate rescue – A consultation* (London : DTI, June 2009) attracted opposition and came to nothing.

³³ Provided the appropriation was communicated by the debtor to the creditor and the creditor did not refuse payment. See *Thomas v Ken Thomas Ltd* [2006] EWCA Civ 1504, [2007] Bus LR 429.

³⁴ *Devaynes v Noble, Clayton's Case* (1816) 8 LJ Ch 256, 35 ER 767. See also Nourse J in *Re Quest CAE Ltd* (1985) 1 BCC 99,389, at 99,393.

will find that it is unsecured for any other remaining or fresh liabilities of the debtor towards the creditor.

14.1.4.1 In the alternative, the security might be in the form of an ‘all moneys’ security, with the intention that it should cover all of the liabilities (present and future, actual or contingent³⁵) of the obligor or other debtor to the creditor. Even so, the courts may find some limitation in the liabilities that are covered by the security. For instance, as a matter of construction the courts would be reluctant to find that the security was intended to cover indebtedness that was not originally incurred to the creditor but of which the creditor had taken an assignment from a third party, although it would appear that by the use of express wording which is unambiguous or otherwise not open to question³⁶ such an eventuality might be covered in terms of the intended application of the security.³⁷ It is submitted, however, that as a matter of public policy such security should not be effective in an insolvency of an obligor, to the extent that it expressly purports to cover assigned debt that was previously unsecured. Otherwise, it could be employed as a device that might be entered into between an assignor (which had been an unsecured creditor of the debtor) and an assignee (which held security in a comprehensive form), by which the assignor received a payment from the assignee in return for the assignment, with the consequential effect of turning previously unsecured debt into secured debt held by the assignee, thereby, arguably, subverting the *pari passu* principle or the anti-deprivation principle.³⁸ However, the *pari passu* principle does not apply to assignments taking place before liquidation or administration, and an assignment of debts in the way described is unlikely to be seen as a deprivation of the company’s assets so as to fall foul of the anti-deprivation principle.³⁹ Another limitation, relating to current accounts, stems from the operation of the rule in *Clayton’s Case*. Where the security covers present and future liabilities stemming from an overdraft and the present debt is paid with a loan secured in favour of another creditor, the bank’s loses priority of its security in relation to any new overdraft if it had notice of another creditor’s secured debt being paid to the account.⁴⁰ This presumption of fact can of course be rebutted by evidence showing the contrary intention of the parties, which is typically the case in modern banking transactions.

³⁵ An example of a contingent liability is one that exists under a guarantee. Until there is a default, the guarantor has no actual monetary liability to make a payment. Once the default occurs and the guarantor becomes liable to pay, however, the liability will crystallise into an actual liability of the guarantor. On the nature of contingent liabilities see Lord Sumption in *Re Nortel GmbH (in administration)* [2013] UKSC 52, at [130]-[132].

³⁶ Lord Clarke in *Rainy Sky SA v Kookmin Bank* [2011] 1 WLR 2900 at [23] stating that if language is unambiguous courts must apply it but *cf* Lord Sumption in *Sans Souci Ltd v VRL Services Ltd* [2012] UKPC 6 at [14] suggesting an arguably wider scope for courts’ role in construction that the real concern is whether the language is open to question with ambiguity being only one of the reasons why might be so open, cited with approval in *Napier Park European Credit Opportunities Fund Ltd v Harbourmaster Pro-rata CLO 2 BV* [2014] EWCA Civ 984 at [36] (Lewison LJ).

³⁷ See *Re Quest CAE Ltd* (1985) 1 BCC 99,389, which concerned the construction of an all moneys clause in a debenture and *Kova Establishment v Sasco Investments Ltd* [1998] 2 BCLC 83, which concerned the construction of a guarantee and a charge. See also *ING Lease (UK) Ltd v Harwood* [2007] EWHC 2292 (QB), in which a similar approach was taken in construing a guarantee.

³⁸ See *Revenue and Customs Commissioners v Football League Ltd* [2012] EWHC 1372 (Ch); [2013] 1 BCLC 285, [4] and [5].

³⁹ For further discussion, see L Hilliard, ‘Assignment of unsecured debts, security and insolvency’ [2014] BJIBFL 626.

⁴⁰ *Deeley v Lloyds Bank* [1912] AC 756 (HL).

14.1.4.2 It is possible for a creditor to assign a liability that is due or owing to it, together with an assignment of the security for such a liability, so long as there is no contractual restriction that would prevent the assignment taking place⁴¹ and that the liability is one that can be assigned as a matter of law. This is recognised by section 114 of the Law of Property Act 1925 and by the Third Schedule to the Act,⁴² which relate to transfers by way of deed of ‘mortgages’, which is defined to include a mortgage or charge of any property for securing money or money’s worth.⁴³ ‘Property’ is defined comprehensively to include any action and any interest in real or personal property. It is clear, therefore, that section 114 is intended to apply to transfers by way of deed of security over all types of asset, with a specific exception for transfers of security bills of sale over chattels.⁴⁴ Section 114 provides that an assignment by way of deed of a mortgage (as defined) is effective to assign the rights and benefit of the transferor in the security and in the liabilities that are secured by it, but this is expressly subject to the mortgagor’s right of redemption. Section 114 is a facilitative provision. It does not provide the only method by which a transfer of security can take place.

14.1.4.3 Despite what has just been said concerning transfers of security, it is submitted that it is not possible to take a bare assignment of security without also taking an assignment of the liabilities to the transferor that were intended to be covered by such security, even if the security document states that the chargee or mortgagee under it includes the successors and assigns of the original beneficiary of the security. Accordingly, the transferee cannot rely upon the security to cover liabilities that the debtor has incurred directly to the transferee as, for instance, liabilities due or owing to the transferee prior to the assignment which were unsecured at the time of the assignment. There are three reasons for this. First, if such an assignment was possible then the effect would be that a previously unsecured creditor would be elevated to the position of being a secured creditor and that would have the effect of subverting the *pari passu* rules of insolvency as they would relate to the position of unsecured creditors of the obligor that had created the security.⁴⁵ Secondly, the granting of security for the liabilities that it is intended to secure is a consensual act, which requires agreement between the parties. It would be contrary to the requirement for such a consensus if liabilities that were originally intended to be unsecured could effectively become secured without the consent of the debtor. Thirdly, the effect of the assignment would be to deny to the obligor the benefit of its equity of redemption upon the discharge of the liabilities that were originally secured by the security.

⁴¹ See 14.1.9.2 below.

⁴² As to the effect of s 114 of the Act in relation to transfers of registered and unregistered land, see *Credit & Mercantile PLC v Marks* [2005] EWCA Civ 760, [2005] 1 WLR 3412 and *Paragon Finance PLC v Pender* [2005] EWCA Civ 760, [2005] 1 WLR 3412, *Meretz Investments NV v ACP Ltd* [2007] EWCA Civ 1303, [2008] Ch 244.

⁴³ See s 205(1)(xvi) of the Act.

⁴⁴ The exception is contained in s 114(5) of the Act.

⁴⁵ This point was adverted to in *obiter* comments in the decision at first instance in *OBG Ltd v Allan* [2001] Lloyd’s Rep Bank 365, at 373. Although the case went on appeal to the Court of Appeal ([2005] EWCA Civ 106, [2005] QB 762) and the House of Lords ([2007] UKHL 21), the point did not arise in the appeals.

14.1.5 Non-recourse security

In the usual case, security is taken to support the primary obligation or personal covenant of the obligor to pay, perform, or be responsible for the relevant liabilities. A consequence of this is that if the security is insufficient to cover the liabilities, the obligor will remain liable for the deficiency under its personal obligation, although that may be of small comfort to a creditor which is faced with an insolvent obligor.⁴⁶ It is possible, however, for the parties to agree that the creditor will confine its right of recourse or recovery to the secured assets, so that it will not have any personal right of recovery against the obligor.⁴⁷ This model is sometimes used in project or property construction finance, under which the relevant financiers agree to take the risk that the project or property assets may not yield a sufficient value to see them whole. No doubt, the interest and fees that they charge for providing the finance will reflect that risk.

14.1.5.1 Other methods of non-recourse financing

There are other techniques by which finance might be provided on a non-recourse basis. Sometimes a transaction might involve a combination of them, together with the use of security without a personal covenant to pay. A brief description will now be given of such other techniques.

14.1.5.1.1 A fairly simple method of achieving an element of non-recourse financing is for the finance to be provided to a subsidiary company in a group, on the basis that the other members of the group, including its parent company, may rely on the normal principle of separate identity in company law, so that they should not be responsible for the borrower's debts and liabilities.⁴⁸ However, there may be situations where the concept of separate identity may be overridden by statutory provisions or by courts, for example where the subsidiary and the parent company are a "single economic unit"⁴⁹ but there is no general principle to pierce the corporate veil and courts will do so only very rarely.⁵⁰ In addition, an action may be brought against the directors and other officers of the borrower if it could be shown that they had engaged in fraudulent or wrongful trading.⁵¹ It is also worth bearing in mind that the liabilities of a subsidiary may have to be included in the consolidated accounts for the parent company and its group.

14.1.5.1.2 It is also possible for a lender to agree that a borrower's obligation to make repayment of its debt, and to pay its other obligations, should be limited by conditions that are set out in the relevant credit agreement. For instance, the

⁴⁶ A secured creditor is entitled to value its security and prove in a liquidation as an unsecured creditor for any deficiency and it is also entitled to prove for a deficiency after it has realised its security: see Rules 4.75 (1)(e), 4.88, and 4.95 of the Insolvency Rules 1986.

⁴⁷ *Mathew v Blackmore* (1857) 1 H&N 762; *De Vigier v IRC* [1964] 1 WLR 1073; *Levett v Barclays Bank PLC* [1995] 1 WLR 1260, at 1271–1272 (Michael Burton QC).

⁴⁸ *Salomon v A Salomon and Co* [1897] AC 22 (HL)

⁴⁹ *DHN Food Distributors Ltd v Tower Hamlets London Borough Council* [1976] 1 WLR 852 (CA) 860 (Lord Denning MR), *Beckett Investment Management Group Ltd v Hall* [2007] EWCA Civ 613, [2007] ICR 1539 para 18 (Maurice Kay LJ).

⁵⁰ See Lord Mance and Lord Clarke in *Petrodel Resources v Prest; Prest v Prest* [2013] UKSC 34, [2013] 2 AC 415, at [100], [102]–[103].

⁵¹ See ss 213 and 214 of the Insolvency Act 1986 (relating to the actions that can be brought by a liquidator). See also Small Business, Enterprise and Employment Act, ss246ZA and 246ZB (not yet in force) which empower administrators to such actions.

borrower's obligation to make payments might be made dependent upon meeting cash flow and other conditions or the prior payment of other creditors.

14.1.5.1.3 In debt or receivables financing, the financier which purchases the debts might be prepared to do so on a non-recourse basis, so that if the underlying debtor defaults in payment of the debts that have been purchased, the financier will suffer the attendant loss. If the financier is not prepared to take that risk then it will require a right of recourse against the seller.

14.1.6 Third party security

It is possible for a guarantor or other type of surety to give security in support of its obligations under the guarantee or other relevant instrument. It follows from what has been said above concerning non-recourse security and as mentioned above that it is also possible for a person to give security over its own assets for the performance of another's (the debtor's) obligations by way of third party security without the giver of the security undertaking a personal obligation by way of guarantee.⁵² Security of the latter type is often referred to as collateral or third party security.⁵³

14.1.7 Security held by a trustee

Where the obligor has liabilities that are owed to several persons and it is not practical for each of them to take separate security then it would be useful if the security could be taken and held by one person on their joint behalves. The utility of this would be further enhanced if that security could be held on behalf of the successors, transferees, and assigns for the time being of such persons, such as the bond holders under a bond issue, where the identity of the bond holders is capable of changing frequently during the lifetime of the issue, or the syndicate members under a syndicate loan facility which contemplates the transference of participations in the facility from time to time by way of novation. This can be achieved under English law by using a security trustee, which would take the security and hold it on trust on behalf of all the syndicate members or bond holders for the time being,⁵⁴ the security being expressed to secure all of the present and future indebtedness, both actual and contingent, that might be due to them.⁵⁵ To assist the trustee in pursuing recovery proceedings and in the enforcement of the security, the documentation under which the security is taken by the trustee is likely to contain a parallel debt provision, by which the indebtedness

⁵² *Re Conley* [1938] 2 All ER 127, in which it was held that the giver of the security would still fall to be considered as a 'surety or guarantor' for the purposes of the forerunners of ss 239 and 340 of the Insolvency Act 1986 (persons who might be preferred under the provisions dealing with preferences).

⁵³ See Rose LJ in *Re Bank of Credit and Commerce International SA (No 8)* [1996] Ch 245, at 254. Although the decision was the subject of an appeal to the House of Lords (decided at [1998] AC 214) this particular point was not controversial.

⁵⁴ One of the basic requirements for the validity of a trust is that there should be certainty as to the composition of the class of beneficiaries under the trust. Notwithstanding the fluctuating nature of the bond holders or syndicate members under such a trust, it is submitted that the appropriate test as to certainty of the beneficiaries in such a situation is that laid down in *McPhail v Doulton* [1971] AC 424, namely, whether at any particular time that it was relevant to determine the identity of the beneficiaries, the trustee could say with certainty that any particular person was or was not a member of the class of beneficiaries.

⁵⁵ The representative capacity of a security trustee in holding security on behalf of the banks as its beneficiaries, was discussed in *British Power & Energy Trading Ltd v Credit Suisse* [2008] EWCA Civ 53. That case concerned a syndicated facility. This is subject, of course, to the terms of the trust deed or other documentation under which the trustee is appointed to hold the security on behalf of the syndicate members, which may place restrictions upon the powers of the trustee.

that was due to the financiers would also be expressed to be due to the security trustee.⁵⁶

It had been thought that security could not be granted to a person unless he was a creditor or a trustee. However, in *Lehman Brothers International (Europe) (in administration)*⁵⁷ Briggs J held that an agreement between a security holder and (B) security grantor (obligor, A) purporting to secure liabilities owed to B and a third party (C) had the effect of creating a right in favour B to resort to the property to discharge liabilities owed to B as well as C. As Briggs J noted, “B may have good business or personal reasons to wish to ensure that A pays his debt to C”.⁵⁸ It is submitted that the decision should not be understood to mean that parties to a security agreement are able to create security *in favour* of third parties in the sense of making them all secured creditors.⁵⁹ The decision, correctly understood, is an authority for the proposition that it is possible for parties to a security agreement to create a security interest which will secure debts owed to other parties. In other words, one security agreement can have the effect of creating one interest in favour of whoever is the party to the agreement, securing debts owed to that party as well as debts owed to others. The decision, however, is controversial. It is difficult, for example, to see how the secured party could enforce security for a debt he is not owed. It is likely to be interpreted narrowly, and that, in most situations, a person taking security for a debt he is not owed will be held to be a trustee or an agent.

14.1.8 Intention to create security

The creation of security is a consensual act of the parties. English law does not automatically give a creditor security merely because it is a creditor or even a particular type of creditor, except in the case of certain creditors who may assert a possessory lien over goods (strictly speaking, this arises as an implied incident of the agreement under which possession of the goods was delivered to the lienee) or certain unpaid vendors of assets or purchasers of such assets who have pre-paid and are entitled to assert an equitable lien (although then the lien arises by operation of law rather than consensually). Apart from those unusual cases, if the creditor is to take and hold security then it must obtain the obligor’s or a third party’s agreement to give the security.⁶⁰ It follows that a prerequisite to the creation of security is that the parties (and, crucially, the obligor or a third party security giver) should intend that security will be created. It will usually be fairly obvious that such was the intention of the parties although it is also possible that whilst the parties may intend to enter into a proprietary transaction other than by way of security, it may be characterised as being in the nature of a secured transaction.

⁵⁶ Such provisions usually go on to state that, to the extent that the indebtedness is paid in the ordinary course under the relevant financial documentation prior to default, such a payment will constitute a *pro tanto* reduction of the liability to make a payment that is due to the trustee.

⁵⁷ [2012] EWHC 2997 (Ch); [2014] 2 BCLC 295 at [43]-[44].

⁵⁸ *Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), [2014] 2 BCLC 295 at [44]-[46].

⁵⁹ This is by contrast to a suggestion in the literature that the agreement creates security in favour of the party to the agreement as well as to a third party, see D Saoul, ‘Lehman: liens untied’ [2013] 3 BJIFBL 143, 144.

⁶⁰ *Palmer v Carey* [1926] AC 703; *Swiss Bank Corp v Lloyds Bank Ltd* [1982] AC 584; *Edwards and Smith v Flightline Ltd*; *Re Swissair Schweizerische Luftverkehr AG* [2003] EWCA Civ 63, [2003] 1 WLR 1200. In none of those cases was it found that the facts supported an agreement to create security.

14.1.8.1 There are situations, however, where a transaction may have the superficial appearance of being in the guise of security but where, on closer examination, it turns out that the necessary intention was lacking, thereby leaving the creditor in an unsecured position. This difficulty is likely to arise where there has been an agreement that moneys should be set aside and only dealt with in a certain way,⁶¹ but it may also arise in other situations as well, such as where there has been an agreement to similar effect concerning securities.⁶² In *Palmer v Carey*⁶³ the Privy Council drew a distinction between two situations in determining if the necessary consensual intention existed for the creation of a proprietary interest by way of security. First, when there was merely an agreement that moneys or other property should be paid into an account or otherwise isolated and could not be dealt with by the payor or other similar person except in an agreed manner. In that situation, no security would arise because there was just a contractual arrangement restricting the use to which the moneys or other property could be put. Even though such a restriction might be protected by the grant of an injunction restraining its breach, it would not amount to the grant of a proprietary interest by way of security. Secondly, the alternative situation was where it was agreed that the moneys or other property should be treated as creating a (specifically enforceable) right to resort to a fund that had been created to discharge a debt.⁶⁴ In other words, that it had been agreed that a proprietary interest in favour of the creditor should be created in the fund or other property, to which the creditor could look for payment and discharge of the liabilities due to it. In the second case, there would be merely an agreement for the creation of security. It should be noted, however, that even though there may be an agreement to create security, it will still be necessary to show that the relevant assets exist and have been appropriated to the security.⁶⁵

14.1.9 Contractual impediments to the creation of security

A person might be precluded by a contractual undertaking that it has given from creating security. The undertaking may be in the form of a negative pledge which restricts that person from entering into transactions by way of security in favour of third parties. Alternatively, the undertaking may amount to a restriction in a contract upon dealing with the rights that arise in that person's favour under the contract. Each of those types of provision is discussed elsewhere in this book, so what follows is limited to a brief summary.

14.1.9.1 Negative pledges

Negative pledges are discussed in more detail in Chapter 3 and in Chapter 12.⁶⁶ A negative pledge is a contractual undertaking in an agreement or security document by which a party (A) to that agreement or document agrees with the other party (B) that A will not create security over its assets, or dispose of those assets, in favour of anyone else (C). In the present context, A as the party that has agreed to be bound by the negative pledge would be the obligor that wishes to create security, and C as the

⁶¹ As was the case in *Palmer v Carey* [1926] AC 703 and in *Edwards and Smith v Flightline Ltd; Re Swissair Schweizerische Luftverkehr AG* [2003] EWCA Civ 63, [2003] 1 WLR 1200.

⁶² As in *Swiss Bank Corp v Lloyds Bank Ltd* [1982] AC 584.

⁶³ [1926] AC 703.

⁶⁴ *Re TXU Europe Group plc* [2003] EWHC 3105 (Ch), [2004] 1 BCLC 519, [35].

⁶⁵ *Mac-Jordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350.

⁶⁶ See also A McKnight, 'Restrictions on Dealing with Assets in Financing Documents: Their Role, Meaning and Effect' [2002] JIBL 193.

third party would be the creditor that is to receive such security. When considering the effect of a negative pledge, it is necessary to check carefully as to the types of transaction that fall within the overall compass of the clause. In addition, there might also be agreed exceptions to the restrictions contained in the clause, and the proposed transaction might come within a permitted exception.

14.1.9.1.1 Negative pledge clauses arise in three different contexts. First, such a clause might be contained in an unsecured facility or other credit or debt raising instrument (such as in the terms and conditions of a bond issue), by which A as the debtor agrees with B as the lender or lenders that it will not create security in favour of third parties such as C. The intention behind such a clause is to maintain the lender's *pari passu* unsecured position with respect to other claimants against the debtor and in the distribution of its assets, particularly in an insolvency of the debtor. Secondly, in a floating charge a negative pledge clause may be used to restrict the types of transaction that A as the chargor might otherwise be able to enter into within the general concept of the liberty to deal with the charged assets in the ordinary course of business. Thirdly, a negative pledge clause should invariably be contained in any security document by which it is intended to create fixed security, so that A as the chargor or mortgagor is precluded from engaging in any dealings with the assets that are the subject of the security. This is necessary to demonstrate that the security is not a floating charge. Under current English law any clauses which are contained in a document creating a charge and which seek to prohibit or restrict the obligor from creating further security ranking equally or ahead of the charge are registrable in the Companies House if the obligor is a company or a limited liability partnership.⁶⁷ Lack of registration within the prescribed period means that the clause is unenforceable against creditors, liquidators and the administrator. Where a negative pledge clause is included in a floating charge, registration will usually serve as notice to prevent subsequent encumbrancers from obtaining priority.⁶⁸

14.1.9.1.2 The principal difficulty⁶⁹ concerning negative pledges, especially the first kind, is in establishing the consequences, as against C, where A breaches the clause and enters into a prohibited transaction in favour of the third party. This comes down to making a determination as to whether the third party is liable to B for the tort of inducing or procuring a breach of the contract between A and B. If so, the third party would be liable in damages (which may not be of much practical utility) but, more importantly, an injunction might be available to B so as to prevent C as the third party from relying upon the benefit of the transaction.⁷⁰ For B to succeed against the third party, it is necessary (in addition to showing that the relevant person (A) had breached the negative pledge) to demonstrate that the third party (C) had the necessary knowledge of the contract and the relevant restriction, that it realised that the relevant person (A) would breach it, and that the third party (C) intended to cause the breach.⁷¹ Such an intention will be lacking, for instance, if the third party had acted on legal advice to the effect that it would not be entering into a transaction

⁶⁷ Section 859D (2)(c) of the Companies Act 2006.

⁶⁸ See section 14.13 below.

⁶⁹ For a discussion of other difficulties with the first kind of negative pledge, see L Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 2013 5th edn) para 1-79 to 1-83.

⁷⁰ See Browne-Wilkinson J in *Swiss Bank Corp v Lloyds Bank Ltd* [1979] Ch 548.

⁷¹ These aspects were explored by Lord Hoffmann in *OBG Ltd v Allan*; *Douglas v Hello! Ltd*; *Mainstream Properties Ltd v Young* [2007] UKHL 21, [2008] 1 AC 1.

which amounted to a breach of the restriction⁷² or if it honestly believed that the relevant person (A) had received consent to enter into the transaction.⁷³

14.1.9.2 Restrictions within a contract upon dealing with rights arising under the contract

Such restrictions would be relevant where an obligor wishes to create security over the benefit of contractual rights in its favour, such as a debt payable to it. It may be precluded from doing so by the terms of a restriction in the contract under which the right arises. These types of restriction are discussed in more detail in Chapter 12.⁷⁴ There are proposals to render contractual terms prohibiting or restricting assignment of receivables ineffective (with some exceptions).⁷⁵

14.1.9.2.1 When considering the effect of a contractual restriction, it is necessary to consider both the contractual rights to which it relates and the types of dealing with those rights that it prohibits or otherwise restricts. This will be a matter of construction of the contract.⁷⁶ For instance, a distinction might be drawn in the terms of the restriction between dealing with unearned rights (such as a right to be paid which will only arise after a service has been performed), which might be prohibited, and dealing with accrued rights that have been earned under the contract (for instance, a right to be paid because the service has been performed).⁷⁷ Similarly, a distinction might be drawn in the construction of the relevant wording between a statutory assignment, an equitable assignment, and a declaration of trust of a contractual right,⁷⁸ or between an assignment by way of mortgage and a charge. Thus, the clause may prevent one or more of those types of dealing but permit the others to occur. From the perspective of a contracting party in whose favour the restriction applies, the more comprehensive the wording of the restriction, the less opportunity the other party will have to enter into dealings relating to its contractual rights. From the perspective of the latter party, it is best to ensure that the terms of the restriction are specifically

⁷² *Meretz Investments NV v ACP Ltd* [2007] EWCA Civ 1303; [2008] Ch 244.

⁷³ Which was the position on the facts in *Mainstream Properties Ltd v Young* [2007] UKHL 21; [2008] 1 AC 1.

⁷⁴ See also A McKnight, 'Contractual Restrictions on a Creditor's Right to Alienate Debts' at [2003] JIBL 1 and [2003] JIBLR 43; Goode, 'Contractual Prohibitions against Assignment' [2009] LMCLQ 300; GJ Tolhurst and JW Carter, 'Prohibitions on assignment: a choice to be made' [2014] CLJ 405.

⁷⁵ Section 1 of the Small Business, Enterprise and Employment Act 2015 conferred a power to introduce a statutory measure to nullify contractual prohibitions against assignment, at the time of writing drafted as Business Contract Terms (Restrictions on Assignment of Receivables) Regulations. Under the draft regulations the nullification of bans on assignment would not apply to contracts to provide various financial services including lending (including consumer credit, mortgage credit, factoring and financing of commercial transactions), see the draft Business Contract Terms (Restrictions on Assignment of Receivables) Regulations, regs 2, 1. See further R Calnan, 'Ban the ban: prohibiting restrictions on the assignment of receivables' [2015] 3 JIBFL 136; H Beale, L Gullifer, S Patterson, 'Ban on assignment clauses: views from the coalface' [2015] 8 JIBFL 463

⁷⁶ See Lord Browne-Wilkinson in *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] AC 85.

⁷⁷ As, for instance, occurred in *R v Chester and North Wales Legal Aid Area Office (No 12), ex p Floods of Queensferry Ltd* [1998] 1 WLR 1496.

⁷⁸ *Don King Productions Inc v Warren* [2000] Ch 291; *Devefi Pty Ltd v Mateffy Pearl Nagy Pty Ltd* [1993] RPC 493, at 505 (Fed Ct of Aust); and *Barbados Trust Co Ltd v Bank of Zambia* [2007] EWCA Civ 148, [2007] 1 Lloyd's Rep 495; for a succinct summary of principles see Stuart-Smith J in *Co-operative Group Ltd v Birse Developments Ltd (In Liquidation)* [2014] EWHC 530 (TCC), [2014] PNLR 21, at [88]. See also *Stopjoin Projects Limited v Balfour Beatty Engineering Services (HY) Limited* [2014] EWHC 589 (TCC).

confined to stated matters and that the relevant clause states what dealings are permitted.

14.1.9.2.2 Because the restriction upon dealing goes to the very heart of the contractual right that it affects and defines the freedom of the relevant party to deal with the right, a purported dealing in favour of a third party that offends against the restriction will be ineffective to confer a proprietary right upon the third party.⁷⁹ This will be the case, whether or not the third party was aware of the restriction or intended to cause a breach of it.

14.1.9.3 Other types of restriction

There may be other types of restriction, principally of a statutory nature, which may prevent a proprietary transaction from taking place, or place constraints as to the circumstances in which it can take place. An example of this is the prohibition upon a public company, or a subsidiary of such a company, giving financial assistance (including by way of giving a guarantee or security) in connection with an acquisition of shares in the public company.⁸⁰ Similarly, a public company may not give financial assistance in connection with an acquisition of shares in a private company, if that company is its parent company.⁸¹ Another example concerns restrictions upon a company in entering into transactions with parties that are connected with it.⁸² A further example concerns dealing in assets that are subject to regulatory restrictions upon transfer or acquisition of such assets, such as the shares in an authorised person which carry ‘control’ of the authorised person, under Part XII of the Financial Services and Markets Act 2000.

14.1.10 Conflict of laws and cross-border issues

A number of issues might arise which may involve cross-border elements and the associated considerations that arise in the subject of conflict of laws. They may include the matters already referred to above and other issues as well, such as whether the relevant asset is capable of being taken as security, and if it is available as security, the liabilities that may be secured and the types of creditor that may hold security, the types of security that are available and the methods involved in taking the security, as well as the attendant procedures and formalities that must be observed (including, for instance, if it is necessary to notarise and register the security), the effectiveness of the security, the ranking and priority of different claimants in the same asset, the creditors which may have preferential claims in an asset, the right to enforce the security and the procedures for enforcement of the security, as well as the effect of an insolvency of the debtor.

14.1.10.1 Those various issues will be examined in this chapter under English law, and the chapter will proceed on the basis that English law governs all of the aspects that are relevant to the subject matter. Nonetheless, conflict of laws

⁷⁹ See, for instance, the strict approach that was taken by the Court of Appeal in *Barbados Trust Co Ltd v Bank of Zambia* [2007] EWCA Civ 148, [2007] 1 Lloyd’s Rep 495 as to the obligation to comply with the precise requirements of the relevant clause before an assignment of the lender’s rights could take place.

⁸⁰ S 678 of the Companies Act 2006 (which prospectively replaces the more comprehensive prohibitions to be found in s 151 of the Companies Act 1985).

⁸¹ S 679 of the Companies Act 2006.

⁸² See the provisions concerning substantial property transactions contained in s 190 et seq of the Companies Act 2006 (which replace the provisions of s 320 et seq of the Companies Act 1985).

considerations are bound to arise in transactions that have a cross-border element, particularly where the relevant asset is located in another jurisdiction. In such cases, one or more foreign laws may govern the various relevant issues and it would be necessary to take advice in the jurisdictions concerned. The conflict of laws and cross-border insolvency aspects are examined further in Chapters 4, 5 and 12. Reference should also be made to Chapter 17 where alternative systems for maintaining secured transactions are discussed. Although the discussion that is contained in this chapter concentrates on the way that English law analyses the issues and deals with them, the discussion may also serve to provide a point of reference for comparative purposes when conflict of laws and cross-border issues arise.

14.2 Concepts of Property, Interests in Property, and Dealings in Property: An Introduction

14.2.1 It is not really possible to comprehend the approach that English law takes to secured and other forms of proprietary transaction without understanding the types of interest that may exist in property (or assets) under English law, as well as the difference between law and equity and the methods by which dealings in property may take place. At the risk of over-simplification of a complex area of study, there now follows a general description of those matters.

14.2.2 Concepts of property

When a person has an interest in an asset, whether by an ownership or a security right, he is said to have a ‘proprietary’ interest in the asset.⁸³ Traditionally, English law distinguishes between real property, which concerns land and certain interests in land, and personal property, which covers everything else (e.g. goods and all types of intangible assets). Somewhat confusingly, English law has also treated some interests in land as ‘chattels real’ and, thus, as being personal property (e.g. a tenant’s rights under a lease). English law also distinguishes between tangible and intangible property. Tangible property includes all forms of real property, as well as goods (sometimes called chattels). These assets have a physical presence. Intangible property covers the remainder, being rights of various kinds which do not have a physical quality, but which the law recognises and protects, whose quality and value is protected by being able to sue so as to enforce the right (e.g. for payment of a debt) or to protect the right against misuse by others (e.g. intellectual property).⁸⁴ Intangible property therefore includes choses in action (e.g. debts) and intellectual property.⁸⁵

⁸³ Against the view that equitable interests are proprietary is the suggestion that they are merely persistent rights against another person with respect to the asset, see: B McFarlane, *The Structure of Property Law* (Hart 2008). The view taken in practice, and followed here is that equitable interests, at least equitable security interests are proprietary in the sense that they are enforceable against at least certain third parties: other creditors, insolvency officers and in some circumstances also purchasers.

⁸⁴ As to what constitutes intangible property, see *National Provincial Bank Ltd v Hastings Car Mart Ltd* [1965] AC 1175, applied for example in *Armstrong DLW GmbH v Winnington Networks Ltd* [2012] EWHC 10 (Ch), [2013] Ch 156, where allowances in relation to CO2 emissions amounted to property.

⁸⁵ English law also recognises as a chattel a documentary intangible (i.e. the physical document comprising an instrument such as a bill of exchange) where the rights of the holder, including the right to enforce it, are encapsulated in the instrument, so that possession of the instrument represents the proprietary entitlement to it and the rights it represents. For practical purposes, this means negotiable instruments.

14.2.2.1 The above is the English law domestic classification of property and assets. Different concepts are employed in categorising assets where there is a foreign or extra-territorial element, involving issues outside the English domestic jurisdiction. This is the area of conflict of laws. The relevant categories in that situation are immovable property (i.e. land and interests in land) and movable property (i.e. the rest, which is split between tangible movables and intangible movables).

14.2.3 Legal and equitable interests in assets

English law distinguishes between legal and equitable interests in an asset. The distinction may be relevant to a security transaction for the following reasons. First, it will affect the method and structure of the transaction. Secondly, it will dictate the types of interest that may arise or be taken. Thirdly, it will be relevant to matters relating to attachment of the security to the relevant assets, as well as perfection and priority issues, and the enforcement of the security.

14.2.3.1 Legal interests

In the original understanding of English law there were only common law (or 'legal') interests, because only the common law existed. The common law recognised one ownership interest, the transfer of which depended on the existence of the asset in the possession of the owner and typically also the delivery of possession or completing of a formal act such as a deed. For example, the transfer of ownership of land depended upon a formal conveyance of the title from the old owner to the new owner; the transfer of ownership of goods in a contract of sale was exceptional as it only depended upon an intention to transfer the property (ownership) in the goods and delivery of possession was not necessary, although it usually accompanied the ownership transfer. Transfer of goods other than by sale required delivery or a deed.⁸⁶ The common law did recognise certain subservient interests in an asset, such as the rights of a tenant to occupy land and the rights of a bailee to possession of goods, but they were less than ownership and were limited. The common law was unable to recognise that the title in an asset might technically be held by one person but in reality or conscience he did so on behalf of a third party (e.g. because the third party was only an infant or a poor widow). On the other hand, the common law did recognise the concept of shared ownership of a legal interest, either as joint tenants or as tenants in common.

14.2.3.1.1 It should also be noted that the common law has never been able to recognise proprietary interests in future property, including property yet to be acquired by the putative owner. It can only deal with what exists. Any transaction at common law concerning such future property could only give rise to a contractual obligation, for which damages could be awarded if the contract was breached. A claim for damages is not much use if the defendant has become insolvent.

14.2.3.1.2 The creation of security at common law followed the same rigid pattern as for transfers of ownership. Security over land (before the 1925 property legislation) in essence involved a formal conveyance of the title by the obligor to the creditor. Discharge of the security required a formal re-conveyance back to the obligor once it had satisfied its obligations. At best, the obligor might be able to point to a contractual right to call for the re-conveyance, but it had no proprietary interest in

⁸⁶ See *Cochrane v Moore* (1890) 25 QBD 57 (CA).

the land in the meantime because it had given up its title. Having no proprietary interest, the obligor was in a weak position.

14.2.3.1.3 The position was a little different with goods. Security could be created by mortgage but historically, as a matter of convenience, it was often done by means of a pledge, which involved giving possession to the creditor and regaining possession once the debt had been paid off. In the case of a pledge, the common law was prepared to recognise two different legal interests, being that of ownership vested in the borrower (the ‘pledgor’) and the ‘special property’ of the security holder (the ‘pledgee’) in the goods. The common law also recognised a right of retention by way of a lien over goods, which was asserted to protect a debt due to the person holding the goods by the person who had delivered possession to him.

14.2.3.1.4 So far as concerned choses in action and other types of intangible property, the common law was unable to recognise dealings (‘assignments’) in such assets, by way of outright transfer or security. Traditionally, such transactions could only take place in equity. This was rectified by section 1 of the Policies of Assurance Act 1867, which allowed for policies of life assurance to be assigned at law for the first time, section 1 of the Policies of Marine Insurance Act 1868 (now section 50 of the Marine Insurance Act 1906), which allowed for the assignment of marine policies, and section 25(6) of the Judicature Act 1873, which is now section 136 of the Law of Property Act 1925, which concerns assignment at law of all other forms of legal choses. There are strict formal requirements that must be met to obtain the benefit of the statutory provisions.⁸⁷ Although the effect of those statutory provisions was to impose upon the common law a system by which it would recognise assignments which met the requisite conditions, it also remained possible to effect transactions in equity to the same extent as had been the case before the passing of the statutes.⁸⁸

14.2.3.2 Equitable interests

It was to overcome the rigidity of the common law that the separate and more flexible jurisdiction of equity was developed by the chancery courts. These courts (which historically operated separately from the jurisdiction at common law) were prepared to impose obligations upon the conscience of parties and also acted to overcome the rigid and formal requirements and restrictions of the common law. For instance, they regarded that as done which ought to be done. In consequence, there developed a recognition in equity of proprietary interests (called ‘equitable’ or ‘beneficial’ interests) which could be superimposed upon the simple legal title recognised at common law. In such a case, equity said that in addition to the underlying legal title held at common law, there was an equitable (or beneficial) title which the chancery courts would protect by directing the parties to take appropriate action, even by issuing restraining and other orders directed at action in the common law courts.

⁸⁷ Section 3 of the Policies of Assurance Act 1867 sets out need for written notice of the date and purport of such assignment given to the assurance company liable at their principal place of business and section 5 of the Act sets out any assignment may be made either by endorsement on the policy or by a separate instrument, needs to be duly stamped. It is interesting to note that the 1867 Act and the 1868 Act pre-dated the provision for the legal assignment of other choses that was provided for by s 25(6) of the Supreme Court of Judicature Act 1873. Formalities under section 136 of the Law of Property Act 1925 are discussed below (14.5.3.1.1).

⁸⁸ See Lord Macnaghten in *William Brandt's Sons & Co v Dunlop Rubber Co Ltd* [1905] AC 454, at 461.

14.2.3.2.1 When there is an equitable interest there will also be an underlying legal interest in the asset. This usually, but not always (see Lord Browne-Wilkinson in *Westdeutsche Landesbank Girozentrale v Islington LBC*⁸⁹), takes the form of equity forcing the holder of the legal interest to hold his interest on trust for the benefit of the person entitled to the beneficial interest. Equity thus developed the concept of the trust. In its simplest form, the trust will be express where it is made clear that one person (the ‘trustee’) will hold the legal title in identifiable assets (the ‘trust property’) for one or more other people (the ‘beneficiaries’). In other cases, equity may impose a trust where the circumstances so require, giving rise to a constructive trust or a resulting trust. Since legislation in the second half of the 19th century,⁹⁰ the common law courts have also been given power to recognise and protect equitable interests and vice versa.

14.2.3.2.2 Equity said that an obligor which had received credit and given a mortgage (the ‘mortgagor’) had an equity of redemption which equity recognised as being a proprietary interest in the asset. The equity of redemption gave the mortgagor the right to regain its legal title from the creditor (the ‘mortgagee’) upon discharge of the secured liability. The chancery court would enforce that right against the mortgagee, even to the extent of arranging for the re-conveyance to be executed if the mortgagee refused to do so. Similarly, equity said that in the case of assets of a special or unique character, where the remedies of the common law were inadequate if the other party failed to honour its contract to transfer the asset, then equity would treat that as done which ought to be done and require fulfilment of the contract. In the meantime, equity would recognise a proprietary interest in the transferee.

14.2.3.2.3 Equity was also prepared to recognise the effectiveness of transactions in the whole or parts of choses in action and other types of intangible property. It did this by the concept of an equitable assignment, to which it attached little in the way of requirements for the observance of formalities, so long as the intention to assign was clear (see Lord Macnaghten in *William Brandt’s Sons & Co v Dunlop Rubber Co Ltd*⁹¹). Such an assignment could be an outright transfer or by way of mortgage.

14.2.3.2.4 Once equity had developed its concept of equitable proprietary interests, it then went on to develop its own concept of security. Such security might arise because the subject of the security was an equitable interest (e.g. the equity of redemption of the mortgagor or the right of a beneficiary under a trust). Alternatively, it might arise because the security was over a common law interest in an asset, but had not fulfilled all of the formal requirements for the creation of security at common law, so long as enough had been done or agreed for equity to recognise the intended consequences of the transaction. In addition, equity developed the charge, which differs from other forms of security in that it does not involve a concept, however notional, of a transfer of title, but simply a “proprietary impediment” upon the asset for repayment of the secured obligation.⁹²

⁸⁹ [1996] AC 669, 706–707.

⁹⁰ Principally under the Supreme Court of Judicature Act 1873.

⁹¹ [1905] AC 454. But there must be, as a bare minimum, a sufficient outward evidence of an intention to assign the relevant subject matter: see Blackburne J in *Finlan v Eyton Morris Winfield* [2007] EWHC 914 (Ch); [2007] 4 All ER 143, [33].

⁹² See Atkin LJ in *National Provincial and Union Bank of England v Charnley* [1924] 1 KB 431, 449–450 and Lord Hoffmann in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, 226.

14.2.3.2.5 Equity was also prepared to go a step further than the common law in relation to transactions concerning future property. As mentioned above, the common law is only able to comprehend in a proprietary sense what exists. In certain circumstances, however, equity is prepared to give proprietary recognition to the effectiveness of contracts concerning future assets, by saying that a beneficial interest will attach to the property upon its acquisition, as if that interest had existed as from the time of contracting (see Lord Macnaghten in *Tailby v The Official Receiver*⁹³). This can be very useful as a security device.

14.2.3.2.6 There are some further points which should be noted. First, that equitable interests cannot exist in a vacuum; there must always be an underlying legal title in an asset. Secondly, equitable and legal interests in the same asset cannot be vested in a sole person; a person can hold both an equitable and legal interest so long as there are some other equitable interest-holders or legal-title holders. If legal and equitable interest were to vest in one and the same person, there would simply be one all-encompassing legal title.⁹⁴ Thirdly, in an ordinary sale of goods transaction, governed by the Sale of Goods Act 1979, equitable interests will not arise as a normal consequence of the transaction.⁹⁵ Fourthly, that there cannot be several legal titles existing at the same time, except in the case of limited subservient entitlements, such as that of the lessee under a lease of land, the bailee of goods, and a pledgee or lienee of goods. Equity, however, has no such qualms and will merrily permit several equitable interests, as well as the underlying legal interest, to exist in the same asset. Fifthly, whilst it is perfectly possible to have equitable security over legal interests, it is not possible to have legal security over equitable interests. There is one possible exception to this that may arise under section 136 of the Law of Property Act 1925 in relation to assignments of equitable choses in action. Sixthly, dealings in future property with a proprietary effect can only take place in equity. Seventhly, the 1925 property legislation introduced previously unknown concepts in relation to real property. For example, it introduced the concept of a charge by way of legal mortgage (which, hitherto, had only been an equitable security) and it also provided that there could be successive charges by way of legal mortgage over the same piece of land. It also left the legal title to the land in the mortgagor. Those “heresies” are confined to security transactions involving real property.

14.2.3.2.7 There is a final point to raise concerning the willingness of equity to recognise and enforce the outcome of an intended proprietary transaction, which will be returned to later in this chapter. It concerns the extent to which equity requires the giving of value by the person who seeks equity’s assistance to recognise a transaction. Value need not always be required, depending upon the circumstances. Value in this context means real or substantial value, as opposed to the nominal value that is understood at common law as being required as the consideration to support a contract. Value, as understood in equity, may consist of a monetary amount, such as an outright payment or an advance by way of loan, or it might consist of some real detriment being suffered, such as the promise to do something, giving up a benefit, or the deferment of a right. In determining if value is required, there are two of equity’s famous maxims that are in play. One that has already been mentioned is that equity treats as done that which ought to be done. Another is that equity will not assist a volunteer (i.e. a person who has not given value).

⁹³ (1888) 13 App Cas 523. See also *Holroyd v Marshall* (1862) 10 HL Cas 161.

⁹⁴ See *Re Bond Worth Ltd* [1980] Ch 228.

⁹⁵ See Atkin LJ in *Re Wait* [1927] 1 Ch 606, 625–641.

14.3 The Concepts of Future Property and Attachment

14.3.1 In general terms, it is possible under English law to take security over just about every type of asset and interest in an asset. As has already been mentioned, English law is prepared to go even further and recognise the proprietary consequences of transactions involving future property, as well as the effect where an asset is converted into proceeds of disposition or other products made from it. There are, however, certain limitations upon the breadth of those statements, as will be seen from the discussion that follows.

14.3.2 Future property

Future property may be defined as property (including an interest in property) that an obligor does not hold at the time that it purports to create security over it (or, indeed, when it enters into any other type of transaction concerning such property). The relevant assets may not yet exist or, whilst existing, they may not yet be owned by the obligor.⁹⁶ Future property will include goods which the obligor will acquire in the future,⁹⁷ debts to become due to the obligor in the future,⁹⁸ dividends not yet declared,⁹⁹ copyright in works not yet written,¹⁰⁰ an expectancy under the will or intestacy of a living person,¹⁰¹ and damages not yet sued for and awarded.¹⁰²

14.3.2.1 It is sometimes difficult to be sure whether the subject matter of a purported dealing is presently existing property or future property by way of a mere expectancy, such as income that might be earned in the future from the use of existing property.¹⁰³ An analogy has been drawn in Australian case law between the ‘tree’, which is existing property, and the ‘fruit’ that the tree may produce tomorrow, next year, or thereafter, which is future property.¹⁰⁴ The difference may be important for a number of reasons, including in determining the true subject matter of an assignment and whether the assignee is entitled to enforce the rights that have purportedly been assigned,¹⁰⁵ the extent of a prohibition on assignment and whether it catches what has

⁹⁶ See *Performing Right Society Ltd v B4U Network (Europe) Ltd* [2012] EWHC 3010 (Ch), [2013] Bus LR 664 para 62.

⁹⁷ *Holroyd v Marshall* (1862) 10 HL Cas 191.

⁹⁸ *Tailby v Official Receiver* (1888) 13 App Cas 523. By contrast, a debt that has been incurred but is payable in the future is presently existing property.

⁹⁹ *Norman v Fed Comr of Taxation* (1963) 109 CLR 9.

¹⁰⁰ *Performing Right Soc Ltd v London Theatre of Varieties Ltd* [1924] AC 1; *Peer International Corp v Termidor Music Publishers Ltd* [2002] EWHC 2675 (Ch), [2004] RPC 22 (the case was subject to an appeal, which did not concern this point: [2003] EWCA Civ 1156, [2004] Ch 212).

¹⁰¹ *Re Lind, Industrials Finance Syndicate Ltd v Lind* [1915] 2 Ch 345.

¹⁰² *Glegg v Bromley* [1912] 3 KB 474.

¹⁰³ See, for instance, the different results (reached by majority decisions) in two Australian cases: *Norman v Fed Comr of Taxation* (1963) 109 CLR 9 and *Shepherd v Fed Comr of Taxation* (1965) 113 CLR 385.

¹⁰⁴ The analogy was drawn by Kitto J in *Shepherd v Fed Comr of Taxation* (1965) 113 CLR 385, at 396.

¹⁰⁵ See, for instance, *Batey v Jewson Ltd* [2008] EWCA Civ 18. In that case, if the assignment had only been of the proceeds of a claim (i.e. the fruit), rather than the right of action itself (i.e. the tree), then the assignee would have been unable to pursue the claim and assert it for the purposes of a set-off of a counterclaim that the assignee wished to establish as against the other party to the litigation. The assignor, having become insolvent and been struck off the register of companies, was not in a position to pursue the counterclaim.

purportedly been assigned,¹⁰⁶ the rights of set-off that may be enjoyed by the assignee,¹⁰⁷ the method of transfer that is employed, and whether value is required to support the transaction¹⁰⁸ and for priority purposes.¹⁰⁹ It may also be important in the context of the discussion, below, as to whether accretions to an asset might be caught within security that is taken over the asset.

14.3.2.2 Whilst the common law is unable to recognise the proprietary effect of transactions involving future property, equity is able to do so, provided that the conditions that it lays down are met. This was originally determined by the House of Lords in *Holroyd v Marshall*,¹¹⁰ which held that an agreement that was intended to vest a proprietary interest in future property in a transferee (in that case, by way of security over future goods) could be effective to do so when the property came into existence in the hands of the transferor.

14.3.2.3 The concept of dealing with future property was developed further by the House of Lords in *Tailby v The Official Receiver*,¹¹¹ which was a case concerning an assignment of future book debts. It was held that equity will recognise the effect of an agreement to assign future property, so that equity will treat the property as vesting in the intended transferee so long as the following conditions are met:

- (1) the transaction is supported by valuable consideration given at or following the time of the agreement (i.e. past consideration is insufficient to support the agreement);¹¹²
- (2) there is sufficient ascertainment in the identity of the relevant assets when they come into existence so that it is certain that they were intended to be caught by the agreement; and
- (3) the intention between the parties at the time of their agreement is that immediately the assets came into existence in the hands of the putative transferor (and without further condition or the exercise of discretion on the part of the transferor) the intended proprietary interest should vest in the transferee. Such a transferee could be either an absolute purchaser or someone taking security. The security could be by way of fixed or floating security.

14.3.2.4 In *Re Lind*¹¹³ it was said that the effect of the principle is that the interest of the intended transferee is treated as having been effective from the date of

¹⁰⁶ See, for instance, *R v Chester and North Wales Legal Aid Area Office (No 12), ex p Floods of Queensferry Ltd* [1998] 1 WLR 1496. This is subject to what was said above about prohibitions on assignment, see 14.1.9.2.

¹⁰⁷ *Batey v Jewson Ltd* [2008] EWCA Civ 18.

¹⁰⁸ As it is not possible to assign future property at law and value is required to support an equitable assignment of future property.

¹⁰⁹ For the purposes of the priority rule in *Dearle v Hall* (*Dearle v Hall*, *Loveridge v Cooper* (1828) 3 Russ 1), which concerns priorities as between competing assignments, it is not possible to give notice to a potential debtor of a debt that does not yet exist. See further the discussion of the rule in Chap 12. For an example of where the scope of an assignment affected priority, see *Performing Right Society Ltd v B4U Network (Europe) Ltd* [2012] EWHC 3010 (Ch), [2013] Bus LR 664.

¹¹⁰ (1862) 10 HL Cas 191.

¹¹¹ (1888) 13 App Cas 523. See, in particular, the speech of Lord Macnaghten where the requirements are clearly set out. His Lordship also dispelled the red-herring linking the recognition of assignments of future property to a requirement that the transaction should be one that was capable of being the subject of a decree for specific performance, which had arisen from what had been said by Lord Westbury in *Holroyd v Marshall* (1862) 10 HLC 191, at 209 and 211.

¹¹² The requirement for valuable consideration in equity is examined further below.

¹¹³ [1915] 2 Ch 345. In *Peer International Corp and ors v Termidor Music Publishers Ltd & ors* [2002] EWHC 2675 (Ch), [2004] RPC 22 Neuberger J said, [74]–[82], that he preferred the analysis in

the agreement to assign and so will apply notwithstanding an intervening insolvency of the intended transferor which occurs after the date of the agreement to assign but before the asset comes into existence.¹¹⁴ For the same reason, the attachment of the security to the asset when it comes into existence, where that occurs after the commencement of a compulsory winding up, will not be treated as a ‘disposition’ for the purposes of section 127(1) of the Insolvency Act 1986. For the purpose of meeting the time limit for registration under section 859A(4) of the Companies Act 2006,¹¹⁵ the relevant period commences to run from the date of the original agreement to create the security, not the date that the security attaches to the asset upon its coming into existence.¹¹⁶ It has also been said that a conditional agreement to give security would be treated as an agreement to give a floating charge and the agreement would be registrable.¹¹⁷

14.3.3 Attachment

An obligor may agree to create security over an asset but the security may not necessarily attach immediately to such asset, in the sense of the asset becoming subject to the security. For attachment to occur, the asset must be sufficiently identified and come into the ownership of the obligor, as well as being sufficiently identified for the purpose of the security. This is particularly relevant in the case where a debtor has agreed to give security over future assets (e.g. ‘all debts which may become owing to me in the future’ or ‘the car that I will buy next week’ or ‘next year’s wheat crop’). Until the relevant asset is in existence, is sufficiently identified for the purposes of the security, and is owned by the obligor, there is nothing on which the security can attach.¹¹⁸ The same analysis will be relevant where the obligor owns an asset but does not identify it with sufficient certainty for security to attach to the asset.

Re Lind to that of the Court of Appeal in *Collyer v Isaacs* (1881) 19 ChD 342, which had doubted that the agreement would be treated as effective, in a proprietary sense, as from the date of the agreement rather than the date the property came into existence. It should be noted that *Collyer v Isaacs* pre-dated the decision of the House of Lords in *Tailby v The Official Receiver*. See further the discussion by Meagher, Gummow & Lehane, *Equity: Doctrines and Remedies* (5th edn, 2015), paras 6-275 to 6-330. The Supreme Court of Canada recently relied on the correctness of *Re Lind* in *Royal Bank of Canada v RADIUS Credit Union Ltd*, 2010 SCC 48, 325 DLR (4th) 635, [20].

¹¹⁴ Where, however, the purported assignor subsequently becomes bankrupt and an asset arises in the course of the trustee in bankruptcy running the business, such an asset will vest in the trustee, despite an earlier purported assignment executed before the assignor became bankrupt: *Re Jones, ex p Nichols* (1882) 22 ChD 782. This is consistent with s 306 of the Insolvency Act 1986, by virtue of which property comprised in the bankrupt’s estate vests in the trustee. The position may be different in a winding up, as the assets of the insolvent company do not vest in the liquidator unless the court, at his request, makes an order vesting the property in the liquidator pursuant to s 145(1) of the Insolvency Act 1986: see Lord Hoffmann in *Cambridge Gas Transportation Corp v Official Committee of Unsecured Creditors of Navigator Holdings PLC* [2006] UKPC 26, [2007] 1 AC 508 and Ramsey J in *Ruttle Plant Hire Ltd v Secretary of State for the Environment and Rural Affairs* [2007] EWHC 2870 (TCC), [2008] 2 All E.R. (Comm) 264.

¹¹⁵ Formerly s 870 of the Companies Act 2006.

¹¹⁶ See also *Independent Automatic Sales Ltd v Knowles* [1962] 1 WLR 974; *The Annangel Glory* [1988] 1 Lloyd’s Rep 45.

¹¹⁷ See Lord Scott in *Smith (Administrator of Cosslett (Contractors) Ltd v Bridgend CBC* [2001] UKHL 58; [2002] 1 AC 336, [63].

¹¹⁸ As discussed above, once the security has attached, it may be treated as having done so from the time of the agreement to give the security.

14.3.3.1 Attachment is a different concept to enforcement. The consequence of attachment of security is that the creditor obtains a proprietary interest in the relevant asset which rests there until such time as the obligor defaults, following which the creditor can move to enforce the security and deprive the obligor of its interest in the asset. Obviously, enforcement cannot take place if the security has not attached to an asset, but the reverse is by no means true. It will be necessary to consider, however, if the foregoing distinction between attachment and enforcement is necessarily the case in relation to floating charges.

14.3.3.2 The rules for attachment differ as between goods and intangible property, so it will be necessary to look at them separately.

14.3.3.3 Goods

The rules governing the passage of property (ownership) in goods are relevant for at least one reason. Attachment of security depends on the obligor's power to dispose of goods. Since this typically refers to the obligor's ownership of the goods, the relevant question becomes whether the obligor is the owner. If the obligor is a buyer who has agreed to give security over the goods that it is to buy, the security cannot attach to the goods until the buyer acquired an interest in them.

At general law, property (ownership) cannot pass under a contract for the sale of the goods until the goods have been specifically ascertained and appropriated to the contract.¹¹⁹ This is the consequence of section 16 of the Sale of Goods Act 1979 and that consequence used to follow even where the goods formed part of a homogenous bulk¹²⁰ in the hands of the seller and it had been agreed that the purchaser's order would be satisfied out of that bulk. Until the specific goods to be supplied to the purchaser had been appropriated to the contract by being physically separated from the bulk, property could not pass to the buyer (nor did any interest in the bulk pass to the buyer), even if the buyer had paid for the goods that were to be purchased.¹²¹

14.3.3.3.1 While the law in relation to transfer of property in bulk has changed to a certain extent, as discussed below, the consequences just described continue to follow with respect to a purported transaction by way of security over unspecified goods or a portion of a homogenous bulk of goods already owned by the obligor.¹²² The security cannot attach until the goods have been identified or, in the case of a bulk, the relevant portion has been identified and separated from the bulk. However, if the obligor agrees to give security over all of the goods it owns or all of its goods meeting a certain sufficient description to make them identifiable (e.g. every red car owned by the obligor), the security will attach to those goods when and if the obligor has ownership of goods that fall within the description.

14.3.3.3.2 The position with respect to a transaction by way of a sale of goods that form part of a bulk¹²³ is governed by the Sale of Goods Act 1979 and is rather

¹¹⁹ *Re Wait* [1927] 1 Ch 606; *Re London Wine Co (Shippers) Ltd* [1986] PCC 121; and *Re Goldcorp Exchange Ltd* [1995] 1 AC 74.

¹²⁰ An appropriate definition of the concept of a bulk is that now contained in s 61(1) of the Sale of Goods Act 1979, which is set out below.

¹²¹ *Re Wait* [1927] 1 Ch 606.

¹²² Unless, perhaps, it is intended that the creditor should receive security over the relevant portion of each and every item comprised in the bulk: *Re London Wine Co (Shippers) Ltd* [1986] PCC 121.

¹²³ Bulk is defined in section 61(1) Sale of Goods Act 1979 as follows: 'bulk means a mass or collection of goods of the same kind which (a) is contained in a defined space or area; and (b) is such

different. Unless a contrary intention appears, where the buyer has made payment for all or some part of its order, which it has been agreed will be satisfied out of an identified bulk,¹²⁴ the buyer obtains in consequence of that agreement a proportionate interest in the bulk, the proportion representing the ratio of its payment to the overall bulk.¹²⁵ There are provisions to deal with a scaling down of the proportion where the bulk is insufficient for all the orders to be satisfied from it and also to impose a deemed consent to dealings in the bulk.¹²⁶ Further, (unless a different intention appears), where the contract is for the sale of part of a bulk and all other orders to be satisfied from the bulk have been fulfilled then the purchaser will become the owner of what remains (whether or not it has made any payment) provided that the quantity of the bulk has been reduced to no more than is sufficient to satisfy the purchaser's order.¹²⁷ It should be noted that these provisions only apply to transactions by way of sale of goods; they do not apply to a transaction by way of a purported grant of security over part of a bulk of goods.¹²⁸

14.3.3.4 Intangible property

Once again, for security over intangible property to attach to the relevant assets, it is necessary that the obligor should own the property and that it is sufficiently identified for the purposes of certainty under the security. The position is different from that relating to goods, however, in a case where the interest over which ownership or security is asserted forms part of a bulk or fund of fungible property of the same kind, provided that the bulk or fund is itself sufficiently identified and that the intended proportionate interest is also clear. In such a case, it is possible to assert the relevant proprietary interest.¹²⁹ It is not clear if a claimant in such a bulk or fund holds its interest as a tenant in common with other claimants or on some other basis, particularly if the composition of the interests in the bulk or fund is changing from time to time. There are also likely to be difficulties where it transpires that the bulk or fund is insufficient to satisfy the claims of all of those interested in it. This issue is addressed further in Chapter 10.

14.3.4 Security bills of sale¹³⁰

Where security is granted in writing over personal chattels¹³¹ by an individual it is necessary to comply with requirements set out in the Bills of Sale Acts 1878-1882.¹³² Under section 5 of the 1882 Act an individual is precluded from giving security over

that any goods in the bulk are interchangeable with any other goods therein in the same number or quantity.⁷

¹²⁴ Such agreement being either at the time of contracting or by subsequent action by the parties.

¹²⁵ Section 20A

¹²⁶ Section 20A(4) and section 20B

¹²⁷ Section 18 rules 5(3) and 5(4). This is as a form of ascertainment by exhaustion.

¹²⁸ S 62(4) of the Sale of Goods Act 1979 provides that the provisions of the Act which concern contracts of sale of goods do not apply to security transactions.

¹²⁹ See *Hunter v Moss* [1994] 1 WLR 452; *Re Harvard Securities, Holland v Newbury* [1997] 2 BCLC 369; *Re CA Pacific Finance Ltd* [2000] 1 BCLC 494; see Briggs J in *Re Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch); [2014] 2 BCLC 295, in particular at [43]-[44], [49]-[52]. See further the discussion in Chap 10.

¹³⁰ See discussion in chapter 17 of the Law Commission's consultation paper on reform of the law on bills of sale.

¹³¹ See *Chapman (t/a Chapman & Co Solicitors) v Wilson* [2010] EWHC 1746 (Ch). See also further below as to the meaning of 'personal chattels'.

¹³² Bills of Sale Act 1878 and Bills of Sale Act (1878) Amendment Act 1882.

chattels of which he was not the true owner at the time the security was taken. Lack of compliance makes the security bill relating to such future chattels void except the grantor. It should be noted that a general assignment by a trader of book debts, whether absolutely or by way of security, should also be registered under Bills of Sale Act 1878 pursuant to s 344 of the Insolvency Act 1986.

14.3.5 Static and transient assets

English law permits security to be taken in both static assets, that is, assets which are intended to have a degree of permanence in the hands of the obligor, and (where the obligor is not an individual) in revolving or transient assets which of their nature are turned over or consumed by an obligor as part of its business. As will be discussed later in this chapter, the latter are best encompassed within a floating charge, whereas the former can be subject to either fixed or floating security.

14.4 An Asset, Fruits of and Substitutions for the Asset, and the Proceeds of Sale of the Asset

14.4.1 In the context of taking and holding security over an asset, it may be necessary to consider if the security will extend to fruits of the asset, such as income earned by the asset, as well as substitutions for the asset and the proceeds of sale of the asset. In one sense, the original asset and such fruits, substitutions, and proceeds are all distinct assets, but a question which arises is the extent to which a security interest in the original asset will extend to those other assets. These matters were considered by Arden LJ in *Buhr v Barclays Bank PLC*.¹³³ While the true ratio of the *Buhr* case may be open to question, the courts have so far chosen not to engage in an extensive discussion of the issues.¹³⁴ The conclusions which her Ladyship drew were as follows, although it is submitted that each of them would be subject to any express agreement to the contrary as agreed between the security giver and the security holder, save in so far as a bona fide purchaser might be affected.

14.4.2 Fruits and substitutions

Security over an asset, whether it be land, goods, or intangible property, carries with it an inherent security right in the fruits of the asset, considered in *Buhr* as accretions to it, such as rent or income earned by the asset. The security will also extend to any asset which is substituted for the original asset, such as upon renewal of a leasehold interest that had been the subject of the security. To that extent, the mortgagor or chargor will be treated as a fiduciary which holds the benefit of the fruits or substitutions for the mortgagee or chargee.

14.4.3 Proceeds of sale of an asset

If with the consent of all the parties an asset is sold subject to the continuance of fixed security over the asset then the security will continue to exist over that asset. The security holder will not be entitled to claim that its security over that asset has been converted into security over the proceeds of sale (although it is submitted that this

¹³³ [2001] EWCA Civ 1223; [2002] BPIR 25. Lord Woolf LCJ and Tuckey LJ agreed. In reaching her conclusions, Arden LJ drew heavily upon commentary that had been provided by Professor Sir Roy Goode in *Commercial Law* (2nd edn, 1995) pp 667–688 and *Legal Problems of Credit & Security* (2nd edn, 1988) p 16.

¹³⁴ *Menelaou v Bank of Cyprus plc* [2013] EWCA Civ 1960, [2014] 1 WLR 854 para 51 (Floyd LJ).

should not prejudice any security over the proceeds that the security holder may hold separately or additionally to the security over the asset that has been sold). If a mortgaged or charged asset is sold with the consent of the security holder, but on the basis that the asset will be sold free of the security, then the security will cease to exist over that asset. Instead, the security holder will be entitled to claim security in the proceeds of the sale. It is traditionally understood that if the asset is sold without the consent of the holder of fixed security, it will be entitled, at its election, to continue to assert its security over the asset, or it will be entitled to treat its security as converted into security over the proceeds of sale. However, an argument has been made that the security holder may be able to assert security in both the asset and its proceeds of sale so long as this does not lead to an excessive recovery.¹³⁵ Of course, if its security was effectively overreached by the sale, as where the purchaser takes free of the security, the security holder may be left effectively to elect that its security should be converted to the proceeds or otherwise it will lose its security. Following the reasoning in *Buhr*, where the security is converted to security in the proceeds of sale, the mortgagor or chargor will be treated as a fiduciary holding the proceeds for the security holder.

14.5 Forms of Security

14.5.1 A distinction is drawn in English law between possessory and non-possessory security. There are different forms of security that fall within those two types of security.¹³⁶ Some types of security arise at common law and some arise in equity. The position was summarised by Millett LJ in *Re Cosslett (Contractors) Ltd*¹³⁷ as follows:

There are only four kinds of consensual security known to English law: (i) pledge; (ii) contractual lien; (iii) equitable charge; and (iv) mortgage. A pledge and a contractual lien both depend upon the delivery of possession to the creditor. The difference between them is that in the case of a pledge the owner delivers possession to the creditor as security, whereas in the case of a lien the creditor retains possession of goods previously delivered to him for some other purpose. Neither a mortgage nor a charge depends on the delivery of possession. The difference between them is that a mortgage involves a transfer of legal or equitable ownership to the creditor, whereas an equitable charge does not.

What follows will expand upon that summary. In addition to the forms of consensual security to which his Lordship made reference, it will also be relevant to refer to two forms of non-consensual security: the possessory lien and the equitable lien.

14.5.2 Possessory security

There are two types of possessory security. They both concern tangible personal property, such as goods and documentary intangibles capable of transfer by delivery, including negotiable instruments, and they both arise at common law. They are the pledge and the contractual or possessory lien.

¹³⁵ See M Raczynska, 'An Uneasy Case of Multiple Tracing Claims in English Law' in L Gullifer and O Akseli (eds) *Secured Transactions Law Reform: Principles, Policies and Practice* (Hart 2016 forthcoming).

¹³⁶ The discussion that follows does not include maritime liens or statutory liens, such as that given to an unpaid seller of goods under ss 39(1)(a) and 41 of the Sale of Goods Act 1979.

¹³⁷ [1998] Ch 495, at 508 (affd [2001] UKHL 58, [2002] 1 AC 336).

14.5.2.1 Pledges

A pledge involves the pledgor (the obligor) giving possession of the relevant property¹³⁸ to the pledgee (the creditor) as security for an obligation owed by the pledgor to the pledgee.¹³⁹ A power of sale for enforcement of the security is an inherent consequence of the security.¹⁴⁰ There are two types of possession that may be taken to constitute the pledge. One type is actual possession, by which the pledgee obtains the physical control of the property.¹⁴¹ The other type of possession is constructive possession, by which the person with possession of the property undertakes to hold the property for the pledgee by entering into an attornment in favour of the pledge,¹⁴² under which it ‘attorns’ to the pledgee.

14.5.2.1.1 It is also possible to constitute a pledge of goods by the pledgee being given possession of the document of title to goods;¹⁴³ the only such document of title which is known to English law is the bill of lading.¹⁴⁴ This procedure is a valuable

¹³⁸ Since the property must be tangible personal property, such as goods or documentary intangibles, it is not possible to have a pledge of the owner’s benefit of hire purchase agreements by a deposit of the agreements, and an agreement to do so will amount to a registrable charge: *Independent Automatic Sales Ltd v Knowles and Foster* [1962] 1 WLR 974.

¹³⁹ Simply obtaining possession on its own is not sufficient without evidence of the intention to create a pledge. This is because possession may be taken for other reasons and so may not evidence the creation of a pledge. For instance, possession might be given to permit the goods to be retained and used, or possession may be taken as a consequence of the creditor enforcing its charge over the goods: *Re Cosslett (Contractors) Ltd* [1998] Ch 495 (upheld on appeal: [2002] 1 AC 336). Evidence that possession was given so as to create the pledge may be recorded in a memorandum, but care must be taken that the memorandum does not constitute an agreement to create a pledge, which might be taken to constitute a bill of sale with the attendant requirements as to formalities and registration under the Bills of Sale Act (1878) Amendment Act 1882 (see section 14.3.4) or, if given by a company, such a pledge might be recharacterised as a charge and require registration (see below 14.13): *Re Townsend* (1886) 16 QBD 532; *Dublin City Distillery Ltd v Doherty* [1914] AC 823 (HL, Ir) 847 and 852-853 (Lord Atkinson and Lord Parker, respectively, stating that where there is no constructive delivery there is no attornment, but contrast the analysis of Lord Sumner at 865 in the same case) or even as having no effect at all (see *Howes v Ball* 108 ER 802; (1827) 7 B & C 481 and see Lord Blackburn in *Sewell v Burdick* (1884) 10 App Cas 74 (HL) 96).

¹⁴⁰ *Pothonier & Hodgson v Dawson* (1816) Holt 383; Cotton LJ in *Re Morrill, ex p Official Receiver* (1886) 18 QBD 222, at 232.

¹⁴¹ For example, *Wrightson v McArthur and Hutchinson (1919) Ltd* [1921] 2 KB 807, where the goods were contained in a separate room in a warehouse which contained no other goods and the pledgee was given the only keys to the room and a licence to enter and remove them. This should be contrasted with *Dublin City Distillery Ltd v Doherty* [1914] AC 823, where the key that was given to the creditor did not give it access, as a second key was also needed.

¹⁴² In theory, the debtor could itself attorn to the creditor to constitute a pledge but this would have to be accompanied by a surrendering of the obligor’s ability to use and control the goods: *Dublin City Distillery Ltd v Doherty* [1914] AC 823. Further, where there is an attornment by the obligor, it may be recharacterised as a bill of sale or a company charge, with attendant registration requirements, see above 14.3.4 (for formalities in relation to bills of sale) and below 14.13 (relating to registration of charges granted by companies). Note that company charges are now registrable even if they are not in writing

¹⁴³ *North Western Bank Ltd v Poynter Son and Macdonalds* [1895] AC 56. The procedures for doing this are illustrated by *Lloyds Bank Ltd v Bank of America National Trust and Savings Assoc* [1938] 2 KB 147.

¹⁴⁴ Not, for instance, a delivery warrant: *Dublin City Distillery Ltd v Doherty* [1914] AC 823 or a warehouse receipt: see e.g. *Impala Warehousing and Logistics (Shanghai) Co Ltd v Wanxiang Resources (Singapore) PTE Ltd* [2015] EWHC 811 (Comm); [2015] 2 All ER (Comm) 234, para 55 (Blair J). Nor will the deposit of hire purchase agreements constitute a pledge of the goods let on hire by the owner under the agreements: *Independent Automatic Sales Ltd v Knowles and Foster* [1962] 1

adjunct to the provision of finance by way of the issuance of a documentary letter of credit, in pursuance of which the issuing bank is presented with the bill of lading under the letter of credit and thereby obtains a pledge of the goods as security for reimbursement by its customer, being the party on whose behalf the letter of credit was opened.

14.5.2.1.2 A trust receipt is a document that is executed by the pledgor in favour of the pledgee, under which the pledgor is allowed to take possession of the goods subject to a pledge and sell them. By virtue of the arrangement, the pledgor obtains possession as trustee for the pledge and so acts on behalf of the pledgee and not on its own account. The consequence of this is that the security under the pledge continues until the goods are sold, when it transfers to the proceeds of sale.¹⁴⁵

14.5.2.2 Contractual liens

A possessory lien depends upon the relevant creditor (the lienee) obtaining possession of goods¹⁴⁶ which it may keep until it has been paid by the obligor (the lienor). It can arise by operation of law (statute or under the common law) or by agreement between the parties. The parties can also extend by contract the scope of a possessory lien which would, in any event, arise by operation of law. Unlike a pledge, a lien does not give rise to a power of sale although a statutory provision¹⁴⁷ and probably also the parties¹⁴⁸ may provide otherwise. It is simply a right to detain the goods.¹⁴⁹ It arises in a context where the goods are delivered to the lienee for some purpose other than by way of security, such as for storage, carriage, or repair in consideration of a payment. The lien may be excluded by the terms of the contract between the parties but it does not mean that it arises as an implied term.¹⁵⁰ A lien may be specific, where it relates to indebtedness incurred by the lienor to the lienee in relation to the particular goods concerned, or it may be a general lien, where the lienee is entitled to keep goods of the lienor for other types of indebtedness. It is possible for the parties to agree that a specific lien should be turned into a general lien. A lienee's rights are subject to ss 246 and 349 of Insolvency Act 1986, regarding enforceability of the lien of books,

WLR 974. In relation to intangible property, certificates of registration of patents or trade marks cannot be pledged so as to create security over the intellectual property.

¹⁴⁵ However, the right of the pledgee can be defeated by a dealing by the pledgor acting as a mercantile agent: *Lloyds Bank Ltd v Bank of America National Trust and Savings Assoc* [1938] 2 KB 147.

¹⁴⁶ An argument that intangibles such as databases could be subject to a common law possessory lien was rejected in *Your Response Ltd v Datateam Business Media Ltd* [2014] EWCA Civ 281, [2015] QB 41, paras 9-34 (Moore-Bick LJ).

¹⁴⁷ Sale of Goods Act 1979, ss 38-39, 41-43 and 48. Note that the seller has right to resell goods not by way of an enforcement of a security but because he accepts the buyer's repudiatory breach of contract: the contract terminates and the seller acquires ownership of goods: see *Ward (RV) v Bignall* [1967] 1 QB 534 (CA). Thus, the seller need not account for surplus proceeds: *Ward (RV) v Bignall* [1967] 1 QB 534 (CA) 543 (Sellers LJ).

¹⁴⁸ In theory, such a lien should be recharacterised as a pledge. However, little turns on this distinction, and it would appear that the validity of the lien will not be imperiled if the parties agree that the lienee should have a power of sale: see *Great Eastern Rly Co v Lord's Trustee* [1909] AC 109; *Re Hamlet International PLC, Trident International Ltd v Barlow* [1999] 2 BCLC 506; *London Flight Centre (Stansted) Ltd v Osprey Aviation Ltd* [2002] BPIR 1115; *Chellaram & Sons (London) Ltd v Butlers Warehousing & Distribution Ltd* [1978] 2 Lloyd's Rep, 412 (CA); *Jarl Tra AB v Convoys Ltd* [2003] EWHC 1488 (Comm), [2003] 2 CLC 1072.

¹⁴⁹ The very act of detention, however, has been held to amount to enforcement of security in the context of an administration of the lienor: see *Bristol Airport plc v Powdrill* [1990] Ch 744. See also *London Flight Centre (Stansted) Ltd v Osprey Aviation Ltd* [2002] BPIR 1115.

¹⁵⁰ *Tappenden v Artus* [1964] 2 QB 185 (CA) 194-195 (Diplock LJ).

papers and other records of the bankrupt or an insolvent company, and paragraphs 43(2) and 44 of Schedule B1 to the Insolvency Act 1986, relating to enforceability of security in company's administration.

14.5.3 Non-possessory security

Non-possessory security may arise at common law or in equity. The security involves acquisition of a proprietary right in the asset by the creditor but until enforcement action is taken the obligor is entitled to remain in possession of the relevant property. In each case, the security arises by virtue of the terms of the agreement between the parties and is dependent upon that agreement, as it is not constituted by the yielding of possession of the relevant asset by the obligor to the creditor.¹⁵¹ The forms of non-possessory security are as follows.

14.5.3.1 Legal mortgage

In technical terms (except in the case of land), a legal mortgage involves a formal conveyance or transfer of the mortgagor's (the obligor's) legal title in the relevant asset to the mortgagee (the creditor). The mortgagor is protected by its equity of redemption¹⁵², in consequence of which it is entitled to a re-conveyance or re-transfer of the property upon discharge of the security. The position is different for land as the security will be in the form of either a charge by way of legal mortgage or a demise for a term of years absolute.¹⁵³

14.5.3.1.1 Where the property which is to be the subject of the security consists of a debt¹⁵⁴ or other legal chose in action¹⁵⁵ a legal mortgage can take place by way of a statutory assignment or novation (although there may also be a requirement of registration¹⁵⁶ or of additional action¹⁵⁷ for a legal mortgage to have the intended effect). A statutory assignment of a book debt or other chose in action requires

¹⁵¹ *Re Cosslett (Contractors) Ltd* [1998] Ch 495 (upheld on appeal: [2002] 1 AC 336).

¹⁵² As discussed above above 14.1.2.

¹⁵³ See ss 85–87 of the Law of Property Act 1925 and s 51 of the Land Registration Act 2002. By virtue of the latter provision, a mortgage of registered land, upon registration, is a charge by way of legal mortgage.

¹⁵⁴ It will still be a debt for this purpose even though litigation for its recovery was contemplated at the time of the assignment: *Camdex International Ltd v Bank of Zambia* [1998] QB 22.

¹⁵⁵ Which may include a right of action in tort or contract if, prior to 1873, equity would have compelled the assignor to pursue the defendant for the benefit of the assignee: *Compania Colombiana de Seguros v Pacific Steam Navigation Co* [1965] 1 QB 101. In other words, the legal chose must be of a type that equity would have regarded as being assignable prior to 1873: *Tolhurst v Associated Portland Cement Manufacturers* [1903] AC 414, at 424; *G&T Earle (1925) Ltd v Hemsworth RDC* (1928) 140 LT 69.

¹⁵⁶ See section 14.13.

¹⁵⁷ For instance, shares in a company, where legal title vests upon being entered in the relevant register: *Torkington v Magee* [1902] 2 KB 636, so that it will be necessary in the case of a mortgage of shares in an unlisted company for the mortgagee to obtain the mortgage instrument, the share certificate, and the relevant share transfer instrument, the latter two of which must be submitted to the appropriate registrar so that the mortgagee can be entered in the register. The position as to shares in a listed company is referred to below. In the case of certain types of intellectual property, it will be necessary for the mortgagee to be registered on the statutory register (i.e. trade marks, patents, and registered designs). With respect to a mortgage of a negotiable instrument, it is necessary for the mortgagee to obtain possession (and, perhaps, endorsement) of the instrument, as well as obtaining execution of the mortgage instrument (as opposed to a pledge of the instrument, where possession (and, perhaps, endorsement) is required to constitute the pledge).

compliance with section 136 of the Law of Property Act 1925.¹⁵⁸ The requirements are that the mortgage must take the form of an absolute written assignment of a (legal or equitable¹⁵⁹) chose under the hand of the mortgagor as the assignor,¹⁶⁰ of which written notice must be given to the debtor. The assignment should be absolute and not conditional or incomplete.¹⁶¹ It must be of the whole of the chose¹⁶² and it must not purport 'to be by way of charge only'. Therefore, when drafting the documents the form of the mortgage by way of assignment and the written notice of it should not be expressed as being limited or only effective until the secured liabilities have been discharged. The absolute and unconditional character of the assignment is not affected if the mortgagee agrees with the mortgagor that the mortgagee will re-convey the chose back to the mortgagor once the secured liabilities have been discharged, thereby recognising the mortgagor's equity of redemption.¹⁶³ Once the statutory requirements are fulfilled, the mortgagee (as a statutory assignee) can sue in his own name.¹⁶⁴

Whilst in a technical sense the mortgage effects a transfer of the mortgagor's rights, the latter retains its equity of redemption so that the mortgage will not affect the validity of the underlying chose that is assigned, nor its recoverability. Accordingly, if the subject of the assignment is the benefit of a contract for the rendering of work or services to the mortgagor and the contract is breached by the other contracting party, so that there is a claim for damages suffered by the mortgagor, the damages will be recoverable even though the breach occurred after the date of the mortgage. It is not a defence to the claim for damages that the mortgagee has suffered no loss. The damages will remain recoverable after a re-conveyance back following discharge of the mortgage.¹⁶⁵

Novation involves substitution of the person of the creditor, replacing an existing debt which was owed to person A with a new debt now owed to person B. It results in a change of parties and requires the consent of all parties involved. Unlike in a legal mortgage effected by way of a statutory assignment, in novation the person of the debtor may not have any equities against the person of a new creditor (B) merely

¹⁵⁸ Or the equivalent under s 1 of the Policies of Assurance Act 1867, for policies of life assurance, and s 50 of the Marine Insurance Act 1906, for marine policies. As to the requirements of s 136, see Chap 12.

¹⁵⁹ There is considerable authority that it is possible to assign at least one type of an equitable chose in action pursuant to s 136 of the Law of Property Act 1925 because, whilst the section speaks of the assignment of a 'debt or other legal chose in action', it then contemplates that notice of the assignment might be given to a trustee: see Younger J in *Re Pain; Gustavson v Haviland* [1919] 1 Ch 38, at 44, and see also *Torkington v Magee* [1902] 2 KB 427, 430–31; *Compania Colombiana de Seguros v Pacific Steam Navigation Co* [1965] 1 QB 101, 121.

¹⁶⁰ An assignment by way of deed, although not being under hand, will meet this requirement: *Marchant v Morton Down & Co* [1901] 2 KB 829. In the case of security interests over securities, cash (bank accounts) or credit claims (receivables owed to banks etc) an assignment may be subject to Reg 4(3) of the Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) as noted later in this chapter.

¹⁶¹ *Re Williams, Williams v Ball* [1917] 1 Ch 1.

¹⁶² *Jones v Humphreys* [1902] 1 KB 10.

¹⁶³ *Tancred v Delagoa Bay & East Africa Rly Co* (1889) 23 QBD 239; *Hughes v Pump House Hotel Co* [1902] 2 KB 190.

¹⁶⁴ Section 136(1) of the Law of Property Act 1925. This difference between a statutory and an equitable assignment does not always matter in practice: while an equitable assignee is generally required to join the assignor, this will not be insisted upon unless necessary: see e.g. *Three Rivers DC v Bank of England* [1996] QB 292 (CA) 313 (Peter Gibson LJ), *Bexhill UK Ltd v Razaq* [2012] EWCA Civ 1376.

¹⁶⁵ *Bovis International Inc v Circle Limited Partnership* (1995) 49 Conv LR 12, [1995] NPC 128.

because they held them against the previous creditor (A).¹⁶⁶ An example of a mortgage by novation is in relation to taking security in registered securities where the taking of security involves an entry of a transfer on the issuer's register.

14.5.3.1.2 In contrast to certain forms of equitable transaction, to which further reference is made below, it is not necessary that the mortgage should be supported by valuable consideration.¹⁶⁷ Accordingly, a legal mortgage of a chose (or indeed, other types of property) may be taken as security for an existing debt, although the transaction may still be vulnerable under various provisions of the Insolvency Act 1986 that are concerned with the re-opening of prior transactions that might constitute a transaction at an undervalue or a preference.¹⁶⁸

14.5.3.1.3 So long as there are no impediments relating to a disposition of the particular asset concerned¹⁶⁹, it is possible to take a legal mortgage over just about any type of existing legal property of an obligor. However, an individual who gives a mortgage (a security bill of sale) of personal chattels¹⁷⁰ must comply with the requirements of the Bills of Sale Act (1878) Amendment Act 1882.¹⁷¹ That includes identifying correctly the mortgaged chattels under section 4 of the Act and meeting the requirements as to attestation and registration of the bill, which must also contain a true statement of the consideration for which it was given, pursuant to section 8 of the Act. The form of the bill must comply with the requirements of section 9 of the Act.¹⁷² Otherwise it will be invalid, either absolutely, or as to the security contained within it.

14.5.3.1.4 A legal mortgage of a ship, or a share in a ship, must comply with the requirements of the Merchant Shipping (Registration etc) Act 1993, including as to registration of the mortgage in the register. An unregistered mortgage can only be equitable and will suffer in terms of priority as against other registered interests. The position is different for mortgages of aircraft, as a failure to register a mortgage under the Mortgaging of Aircraft Order 1972¹⁷³ or in the International Registry under Regulation 14 of the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015¹⁷⁴ is relevant to priorities but not the nature of the security. Registration requirements also exist in relation to a mortgage over certain

¹⁶⁶ The precise effect of the novation in this regard is a matter of agreement between the parties, see *Graiseley Properties Limited v Barclays Bank plc* [2013] EWCA Civ 1372.

¹⁶⁷ *Nanney v Morgan* (1887) 37 ChD 346, at 352; *Re Westerton, Public Trustee v Gray* [1912] 2 Ch 104; *Walker v Bradford Old Bank Ltd* (1884) 12 QBD 511.

¹⁶⁸ Ss 238, 239, 339, and 340 of the Insolvency Act 1986.

¹⁶⁹ These may become void in some circumstances if the draft Business Contract Terms (Restrictions on Assignment of Receivables) Regulations 2015 are adopted, see discussion 14.1.9.2.

¹⁷⁰ Strictly speaking, the expression 'bill of sale' is narrower than the concept of a mortgage and the expression 'personal chattels' is narrower than simply referring to goods. By virtue of s 3 of the 1882 Act, both expressions have the definitions given to them by s 4 of the Bills of Sale Act 1878. The consequence of this is that there are various exclusions from what might normally be thought of as being included within a chattel mortgage, including mortgages of ships, goods in foreign parts or at sea, bills of lading, and the assets of companies, wherever incorporated (see also s 17 of the 1882 Act and *Slavenburg's Bank NV v Intercontinental Natural Resources Ltd* [1980] 1 WLR 1076). Aircraft are also excluded by virtue of Art 16(1) of the Mortgaging of Aircraft Order 1972 (SI 1972/1268). There is also an exemption for certain imported goods under s 1 of the Bills of Sale Act 1890.

¹⁷¹ The Law Commission's recent Consultation Paper on reform of the law on bills of sale is discussed below in chapter 17.

¹⁷² Which must be in the form of a deed of indenture: see the Schedule to the Act.

¹⁷³ SI 1972/1268.

¹⁷⁴ SI 2015/912.

types of intellectual property, namely trade marks¹⁷⁵, patents¹⁷⁶, and registered designs¹⁷⁷.

14.5.3.2 Equitable mortgage

An equitable mortgage takes the form of an equitable transfer or assignment of the relevant property.¹⁷⁸ It may arise because:

- (i) the subject matter of the security is equitable property (for instance, a mortgagor might wish to mortgage its equity of redemption or a person that has a beneficial interest may wish to give security over that interest);
- (ii) the formalities that are required for a legal mortgage of legal property have not been fulfilled (for instance, where notice of an assignment of a chose in action has not been given to the debtor or where the security is by way of an uncompleted agreement to give a legal mortgage);
- (iii) the property is not transferable at law (as was the position prior to 1873 with respect to choses in action and remains the case with respect to an assignment of only part of a chose);¹⁷⁹ or
- (iv) the form of transaction could not meet the requirements for a legal assignment (for instance, an assignment that is expressed to be by way of security until discharge of the secured obligations which is, in the words of section 136 of the Law of Property Act 1925, by way of charge only).

14.5.3.2.1 There is little that is required by way of formalities for an equitable mortgage, but it must at least be clear in the case of intangible property (and the same should apply to other types of property as well) that the mortgagor, as the equitable assignor, clearly intends the transaction to take place,¹⁸⁰ and that such intention is manifested in some outwardly observable manner.¹⁸¹ There are, however, two further requirements that may have to be met in certain (but not all) circumstances. They concern the need for the security to be in writing and that the creation of the security should be supported by the giving of valuable consideration. Those two requirements, when they are applicable, will apply whether the transaction is in the form of an equitable mortgage or an equitable charge. The necessity to meet those requirements is discussed in Chapter 12. Although those passages address the assignments of debts, what is said there will also apply to taking security over both tangible and intangible property more generally. What follows is intended merely to provide a summary.

14.5.3.2.2 Writing is required where the subject matter of the security that is to be taken consists of an equitable interest in property.¹⁸² An agreement in writing signed by both parties is also required for the creation of any security over an interest in land,¹⁸³ including by way of a deposit of title deeds.¹⁸⁴ For practical reasons, however,

¹⁷⁵ S 25 of the Trade Marks Act 1994.

¹⁷⁶ Ss 30-33 of the Patents Act 1977.

¹⁷⁷ S 19 of the Registered Designs Act 1949.

¹⁷⁸ For a fuller discussion as to equitable assignments, which is also relevant in this context, see Chap 12.

¹⁷⁹ *Bank of Liverpool and Martins Ltd v Holland* (1926) TLR 29.

¹⁸⁰ See the famous statement of Lord Macnaghten in *William Brandt's Sons & Co v Dunlop Rubber Co Ltd* [1905] AC 454, at 462.

¹⁸¹ See Blackburne J in *Finlan v Eytton Morris Winfield* [2007] EWHC 914 (Ch); [2007] 4 All ER 143, at [33].

¹⁸² S 53(1)(c) of the Law of Property Act 1925.

¹⁸³ S 2 of the Law of Property (Miscellaneous Provisions) Act 1989.

¹⁸⁴ *United Bank of Kuwait v Sahib* [1995] 2 All ER 973.

it is always sensible that the security should be in a written form, so that there can be no doubt as to the scope of the security and the relevant terms that should apply to it, as well as demonstrating that the obligor intended to create the security. It should also be noted that the powers of enforcement of security under section 101 of the Law of Property Act 1925 depend upon the security being in the form of a deed.

14.5.3.2.3 The question of value arises in connection with the taking of security for outstanding and unsecured liabilities that already existed at the time the security was taken. The concept of value in equity means real and substantial value, such as the making of further advances or the suffering of a real detriment, giving up a right or postponing it for some meaningful period, or a forbearance to sue for repayment of outstanding indebtedness.¹⁸⁵ Value is always required in connection with any proprietary dealing with future property.¹⁸⁶ Value is also required to support the giving of an equitable charge.¹⁸⁷ Even in cases where value is not required in an equitable sense to establish the validity of the security, the transaction may still be vulnerable under various provisions of the Insolvency Act 1986 that are concerned with the re-opening of prior transactions that might constitute a transaction at an undervalue or a preference.¹⁸⁸

14.5.3.2.4 It is sometimes thought (and indeed it was the view expressed in the previous edition) that it is not possible for an individual to give a written form of equitable security, whether by way of equitable mortgage or equitable charge, over goods. However, section 4 of the Bills of Sale Act 1878 defines “bill of sale” as including “assignments (...) and also any agreement, whether intended or not to be followed by the execution of any other instrument, by which a right in equity to any personal chattels, or to any charge or security thereon, shall be conferred”. This suggests that equitable mortgages and charges are within the scope of the 1878 Act and so the preferable view is that an individual is able to give a written form of equitable security.¹⁸⁹

14.5.3.3 Equitable lien

An equitable lien arises by operation of law and does not depend upon the lienee gaining possession of the relevant property. In many senses, the consequence of such a lien is similar in effect to an equitable charge. However, because the lien arises by operation of law and so is not ‘created’ by the lienor, it is not a registrable charge for the purposes of section 859A of the Companies Act 2006.¹⁹⁰

14.5.3.3.1 An equitable lien arises to secure to a vendor of property payment of the purchase price.¹⁹¹ It will also arise to secure to a purchaser repayment of any part of the price already paid if the transaction fails to proceed to completion.¹⁹² A person who extends credit which is used to pay the vendor is entitled to be subrogated to the

¹⁸⁵ See *Glegg v Bromley* [1912] 3KB 474.

¹⁸⁶ *Tailby v The Official Receiver* (1888) 13 App Cas 523.

¹⁸⁷ *Re Earl of Lucan, Hardinge v Cobden* (1890) 45 Ch D 470.

¹⁸⁸ Ss 238, 239, 245, 339, and 340 of the Insolvency Act 1986.

¹⁸⁹ See s 9 of and the Schedule to the Bills of Sale Act (1878) Amendment Act 1882. See also discussion above in section 14.3.4.

¹⁹⁰ Formerly s 860 of the Companies Act 2006. See *London and Cheshire Insurance Co Ltd v Laplagrene Property Co Ltd* [1971] Ch 499.

¹⁹¹ *Re Birmingham* [1959] Ch 523.

¹⁹² *Rose v Watson* (1864) 10 HL Cas 672; *Chattey v Farndale Holdings Inc* [1997] 1 EGLR 153, in which it was said that the principle did not depend upon the availability of specific performance.

seller's lien.¹⁹³ However, if the party that would be entitled to the lien agrees to take security for the relevant obligation, then the lien will not arise,¹⁹⁴ even if the security is or becomes unenforceable, for instance through failure to register in the Companies Registry.¹⁹⁵

14.5.3.3.2 Generally speaking, an equitable lien can arise in relation to most types of property,¹⁹⁶ although it probably cannot arise under an ordinary contract for the sale of goods. This is because the Sale of Goods Act 1979 provides a complete code as to the passing of title, and equitable interests cannot arise in consequence of the contract.¹⁹⁷ However, where the contract is one for the building and supply of goods to a special order or specification, an equitable lien can arise, at least in favour of a purchaser which has prepaid and a person who has financed the purchaser.¹⁹⁸

14.5.3.4 Equitable charge

An equitable charge (sometimes called a hypothecation¹⁹⁹) differs from an equitable mortgage in that it does not involve the concept, however notional, of a transfer of title. Instead, it effects a proprietary impediment upon the asset by way of security for repayment and discharge of the secured obligation.²⁰⁰ There are two types of equitable charge, namely, the fixed charge and the floating charge. The floating charge is dealt with separately below, so the present discussion will focus on the fixed charge.

14.5.3.4.1 A fixed equitable charge may be taken in the same circumstances in which an equitable mortgage may be taken, with respect to both present and future property, and the comments that are made above in relation to the requirements in taking an equitable mortgage (particularly as to need for writing and valuable consideration) are also applicable to taking a fixed equitable charge.²⁰¹ There is no particular form that is required to create a charge, so long as the intention to do so is clear.²⁰² An agreement to create a trust over an asset as security for performance of an

¹⁹³ *Orakpo v Manson Investments Ltd* [1978] AC 95.

¹⁹⁴ *Capital Finance Co Ltd v Stokes* [1969] 1 Ch 261; *London and Cheshire Insurance Co Ltd v Laplagrene Property Co Ltd* [1971] Ch 499.

¹⁹⁵ *Orakpo v Manson Investments Ltd* [1978] AC 95; *Capital Finance Co Ltd v Stokes* [1969] 1 Ch 261; *London and Cheshire Insurance Co Ltd v Laplagrene Property Co Ltd* [1971] Ch 499; *Burston Finance Ltd v Speirway Ltd* [1974] 1 WLR 1648. The position may be different if the security was invalid from the outset: *Nottinghamshire Permanent Benefit Building Soc v Thurstan* [1903] AC 6; *Orakpo v Manson Investments Ltd*.

¹⁹⁶ It applies to real property: *Rose v Watson* (1864) 10 HL Cas 672; *Re Birmingham* [1959] Ch 523; and personal property: *Re Stucley, Stucley v Kekewich* [1906] 1 Ch 67 (apart from goods).

¹⁹⁷ *Transport and General Credit Corp Ltd v Morgan* [1939] Ch 531; *Re Wait* [1927] 1 Ch 606 (CA) (Sargant LJ dissenting).

¹⁹⁸ *Swainston v Clay* (1863) 3 De GJ & Sm 558, 562; *Hewett v Court* (1983) 149 CLR 639; *International Finance Corp v DSNL Offshore Ltd* [2005] EWHC 1844 (Comm), [2007] 2 All ER (Comm) 305.

¹⁹⁹ *Lowe v National Insurance Bank of Jamaica* [2008] UKPC 26.

²⁰⁰ See Atkin LJ in *National Provincial and Union Bank of England v Charnley* [1924] 1 KB 431, at 449–450; Slade J in *Re Bond Worth Ltd* [1980] Ch 228, at 250; and Lord Hoffmann in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, at 226.

²⁰¹ The giving of valuable consideration is a pre-requisite for an equitable charge: *Re Earl of Lucan, Hardinge v Cobden* (1890) 45 ChD 470.

²⁰² See Romer J in *Cradock v Scottish Provident Institutions* (1893) 69 LT 380, at 382 (affd (1894) 70 LT 718).

obligation will constitute security, most probably in the form of a charge (which might be either a fixed or floating charge, depending upon the circumstances).²⁰³

14.5.3.4.2 For most purposes, the distinction between a fixed equitable charge and an equitable mortgage is of little relevance, as they will each confer an effective form of equitable security, the consequences for priority purposes will be the same, and, provided the security document that is used is in the form of a deed, the same enforcement remedies will arise under section 101 of the Law of Property Act 1925. Indeed, the two are often conflated and referred to in the same way, even by statute.²⁰⁴ In strictly technical terms, the discharge of a charge does not result in a re-conveyance or re-transfer of the secured property to the chargor as no conveyance of title occurred when the charge was granted. In more practical terms, the distinction may have some relevance in considering the effect of taking security over a credit balance or other contractual right that is owed by the chargee to the chargor, which will be referred to at a later point in this chapter. It is also relevant where the subject of the security is a chose in action against a third party. As there is no transfer of the chargor's title in the chose, the chargor must remain as the person that should sue the third party for performance, and the chargor will also be the person who can grant a good discharge to the third party.²⁰⁵ If the chargor refuses to co-operate then the chargee will need the assistance of the court to compel the chargor to act.²⁰⁶

14.5.3.5 Debenture

The expression 'debenture' is used in various different contexts in English law. For instance, in section 738 of the Companies Act 2006 it is defined to include 'debenture stock, bonds and any other securities of a company, whether or not constituting a charge on the assets of the company'. By contrast, in relation to the giving of security the expression is used to mean a security document by which a company gives comprehensive security for indebtedness due to a creditor such as a bank, such security being over all or substantially all of its assets. The security will normally be by way of a combination of fixed security over those assets that are susceptible to such security and floating security over the remainder of its assets. When the term "debenture" is used in a contract, it will be given its ordinary meaning (unless there is a reason to do otherwise) of any document that creates or acknowledges a debt, such as a simple loan agreement, which need not include a charge.²⁰⁷

14.6 Floating Charges

14.6.1 Introduction

It has already been seen that English law developed the concept that security could be taken over future assets, so that the assets would come within the security when they

²⁰³ See Slade J in *Re Bond Worth Ltd* [1980] Ch 228, at 250 and Jonathan Parker J in *Re ILG Travel Ltd* [1996] BCC 21, at 44–45.

²⁰⁴ See s 859A(7) of the Companies Act 2006 (formerly s 861(5) of the Companies Act 2006).

²⁰⁵ This may be contrasted with the position where there has been an assignment by way of mortgage under s 136 of the Law of Property Act 1925 and, it would appear, where the assignment was equitable, at least if notice of the assignment was given to the debtor: *William Brandt's Sons & Co v Dunlop Rubber Co Ltd* [1905] AC 454; *Three Rivers DC v Governor and Co of the Bank of England* [1996] QB 292.

²⁰⁶ A power of attorney taken under s 4 of the Powers of Attorney Act 1971 would be an alternative.

²⁰⁷ *Fons Hf v Corporal Ltd* [2014] EWCA Civ 304.

were acquired by the obligor. It then became necessary to consider if security could be taken, not just over assets that the chargor might wish to acquire from time to time, but also over assets (often the same assets as those that might be suitable candidates to fall within an after-acquired property clause in a security instrument) that it might wish to deal with, that is, dispose of or consume, in the course of its business, without the necessity of obtaining specific releases from the creditor each time a disposal or consumption was to take place. Taking the continuum of such types of asset from acquisition to disposal or consumption, in the context of their acquisition and use for the purposes of the chargor's business, it could be said that the assets were of a fluctuating or circulating nature. In other words, that they would be turned over in the course of the business, with the likelihood that assets would be acquired on a fairly repetitive basis to replace those that were, also repetitively, disposed of or consumed. If such assets were not available as security then a considerable portion of a company's current assets would be ignored in determining the availability of credit, and financiers might not be so willing to extend finance to the company to assist in the financing of the business. On the other hand, if such assets upon acquisition were tied up in a form of fixed security, without the right to deal with them and use them, then the company would be unable to carry on its business. The equitable floating charge was developed in the second half of the nineteenth century to permit incorporated business to give such security over assets which were of a fluctuating or circulating nature.²⁰⁸

14.6.1.1 The state of affairs under which the chargor is able to deal with the charged assets under a floating charge continues until such time as the right to do so is taken away. At that point, the charge is said to 'crystallise', when it becomes a fixed charge with respect to the assets then or thereafter within its compass. This is also called the process of 'crystallisation'.

14.6.1.2 A word of caution must be introduced at this point. Whilst it is helpful in understanding the historical development of the floating charge to describe the matter in the context of assets that typically are of a circulating or fluctuating character, that is not the determinative test for ascertaining in any particular case if a charge is a floating charge or a form of fixed security. As was made clear in *Agnew v Commissioner of Inland Revenue*,²⁰⁹ often referred to as the *Brumark* case after the name of the company which had given the security in that case (to which reference is made below) and other cases as well, what is important is whether the chargor is able to deal with the charged assets free of the security, freely and without the chargee's consent, or whether, on the other hand, that liberty has been entirely removed so that the assets are subject to the real control of the chargee. It is only in the latter case that there will be fixed security. The reason why the requisite element of control is not present is usually because the assets are needed for use by the chargee in dealing with them in its business, and that is typified by assets that are characteristically of a circulating or fluctuating nature. Nonetheless, it is possible to take a form of fixed security over an asset that is normally associated with a floating charge, if the chargor's ability to deal with it is frozen. Similarly, it may be found that an asset that

²⁰⁸ As Lord Millett pointed out in *Agnew v Commissioner of Inland Revenue* (also known as *Re Brumark Investments Ltd*) [2001] UKPC 28, [2001] 2 AC 710, the earliest cases were *Re Panama New Zealand and Australian Royal Mail Co* (1870) LR 5 Ch App 318; *Re Florence Land and Public Works Co, ex p Moor* (1878) 10 ChD 530; *Re Hamilton's Windsor Ironworks, ex p Pitman & Edwards* (1879) 12 ChD 707; and *Re Colonial Trusts Corp, ex p Bradshaw* (1879) 15 ChD 465.

²⁰⁹ [2001] UKPC 28, [2001] 2 AC 710.

is usually associated with fixed security is subject only to a floating charge because the chargor has been given a liberty to deal with the asset.

14.6.1.3 Floating charges were developed as a form of corporate security.²¹⁰ Largely for historical reasons to do with the doctrine of reputed ownership in bankruptcy, which no longer applies, they were not available as a form of security that might be given by individuals.²¹¹ In addition, as a consequence of legislation, an individual cannot give a floating charge over most types of personal chattels.²¹²

14.6.1.4 A valuable explanation of the historical development of the floating charge and of the essential nature of a floating charge, as compared with fixed security, was provided by Lord Millett in giving the advice of the Privy Council in *Agnew v Commissioner of Inland Revenue*.²¹³ The advice that his Lordship delivered in that case should be regarded as required reading for anyone who wishes to study this subject.

14.6.2 The importance of the distinction between fixed security and floating charges

Before progressing further in examining the nature and characteristics of a floating charge, it is worth mentioning briefly the importance of the distinction between fixed security and floating charges. Many of the reasons for the distinction will be dealt with in more detail at a later stage, so what follows is by way of summary to give a general perspective. The discussion will begin by examining the advantages of taking floating security. It then turns to the disadvantages of such security. From the overall perspective of a creditor which wishes to take security, it has to be admitted that the advantages are outweighed by the disadvantages.

14.6.2.1 Advantages

In the first place, as adverted to above, a floating charge can be taken over fluctuating or circulating assets of a business in circumstances where it would not be possible, in a practical sense, for the assets to be the subject of fixed security, as the company would be unable to carry on its business if it was subject to the restrictions associated with giving fixed security. This is because it is of the essence of fixed security that the obligor cannot deal with the assets without the consent of the creditor, which means, for instance, that the obligor cannot have access to the secured assets to dispose of them and it cannot use the proceeds of such a disposition to make payments. In this sense, it might be said that the floating charge provides security where it might not

²¹⁰ Lord Hoffmann made a passing reference to this in *Aquachem Ltd v Delphis Bank Ltd* [2008] UKPC 7, [2008] BCC 648. The fact that the security was developed in a corporate context is clear in the famous statement that is taken from the judgment of Romer LJ in *Re Yorkshire Woolcombers' Association Ltd* [1903] 2 Ch 284, at 295, which is quoted below.

²¹¹ See Lord Millett in *Agnew v Commissioner of Inland Revenue* [2001] UKPC 28; [2001] 2 AC 710, at [8]. Apart from personal chattels that are the subject of the Bills of Sale Act (1878) Amendment Act 1882, there would appear to be no reason why the courts should not now be able to recognise the ability of an individual to give a floating charge, particularly over business assets, but it may now be too late for this development to occur.

²¹² This is the consequence of ss 4 and 5 of the Bills of Sale Act (1878) Amendment Act 1882, to which there is an exception in s 6 of that Act (although the ambit of that exception is cut down by s 9 of the Act). Further exceptions arise with respect to agricultural assets under the Agricultural Credits Act 1928. For discussion of reform proposals, see Chapter 17.

²¹³ [2001] UKPC 28, [2001] 2 AC 710.

otherwise be available, and it permits the company to carry on its business, and thus its ability to generate cash flow, for the benefit of all concerned.

14.6.2.1.1 Secondly, the presence of a floating charge as part of a package of comprehensive security over the whole or substantially the whole of a company's assets formally permitted the creditor to appoint an administrative receiver of the company and its assets.²¹⁴ The right to make such an appointment, however, was abolished by section 72A of the Insolvency Act 1986,²¹⁵ except in relation to certain types of charges, mainly to do with the financial markets and project finance.²¹⁶ A creditor which is the 'holder of a qualifying floating charge'²¹⁷ may appoint an administrator out of court or, if another person makes an application to the court for an appointment of an administrator, may indicate its candidate, whom the court cannot refuse unless the particular circumstances of the case so dictate.²¹⁸ This is useful in determining who should be appointed,²¹⁹ although, at least in theory, the creditor cannot influence what should happen thereafter in the conduct of the administration.²²⁰ In rare cases where the holder of the qualifying floating charge applies to court for an appointment of an administrator, it benefits from an absolution from the requirement to show that the company is unable to pay its debts.²²¹ When the company is in liquidation the holder of a qualifying floating charge enjoys the benefit of an exception to the restriction on administration applications.²²² Upon making the order for administration pursuant to such an application the court discharges the winding-up order.²²³

14.6.2.2 Disadvantages

The disadvantages of a floating charge are all borne by the creditor which holds such a charge.

²¹⁴ The definition of an 'administrative receiver' is contained in s 29(2) of the Insolvency Act 1986. An administrative receiver has considerable powers with respect to the management of the company and dealing with its assets (See, for instance, s 42 of and Sched 1 to the Insolvency Act 1986) and acts on behalf of and owes duty to the debenture holder, not the company, to facilitate the enforcement of the security (*Re B Johnson & Co Builders Ltd* [1955] Ch 634 (CA) 661-662 (Jenkins LJ), cited with approval by Lord Templeman in *Downsview Nominees Ltd v First City Corp Ltd* [1993] AC 295 (PC) 313-314; see also *International Leisure Ltd v First National Trustee Co UK Ltd* [2012] EWHC 1971 (Ch), [2013] Ch 346 paras 28-32.)

²¹⁵ This is discussed further below 14.17.9.

²¹⁶ See sections 72B – s72GA Insolvency Act 1986 discussed below at 14.7.9. Where, in a case falling within one of these exceptions, an administrative receiver is appointed, the creditor by doing so is able to defeat the subsequent appointment of an administrator (paras 17(b), 25(c), and 39(1) of Sched B1 to the Insolvency Act 1986) and the commencement of a moratorium with respect to an eligible company where there is a proposal for a voluntary arrangement of the company (para 4(1)(c) of Sched A1 to the Insolvency Act 1986).

²¹⁷ Which is defined in paras 14(2) and 14(3) of Sched B1 to the Insolvency Act 1986.

²¹⁸ See para 36 of Sched B1 to the Insolvency Act 1986.

²¹⁹ See para 14 of Sched B1 to the Insolvency Act 1986.

²²⁰ In practice, a floating charge holder may well put pressure on the directors of the company to appoint an administrator out of court under para 22 of Sched B1 of the Insolvency Act 1986 rather than make the appointment itself.

²²¹ See para 35 of Sched B1 to the Insolvency Act 1986. See *AIB Group (UK) Plc v St John Spencer Estates and Development Ltd* [2012] EWHC 2317 (Ch), [2013] 1 BCLC 718.

²²² See paras 37(1) and 37(2) of Sched B1 to the Insolvency Act 1986.

²²³ See para 37(3) of Sched B1 to the Insolvency Act 1986. See *Re Albany Building Ltd* [2007] BCC 591 for the effect of dispositions made under a discharged winding-up order.

14.6.2.2.1 The first and most general disadvantage results directly from the chargor's liberty to deal with the assets without the chargee's consent in the ordinary course of its business. The chargee's interest in the charged asset may be defeated by, or subordinated, to an interest of a buyer or anyone with whom the chargor deals in relation to the charged assets. As will be seen from what is said below, the concept of dealing in the ordinary course of business has been developed rather liberally by the case law.

14.6.2.2.2 Secondly, there are a number of statutory provisions which confer priority on various persons with respect to floating charge assets and their proceeds of realisation, ahead of the interests of the holder of the floating charge (irrespective of whether the charge has crystallised). These are referred to in greater detail below.

14.6.2.2.3 Thirdly, the rights of the chargee suffer if the chargor is in administration or if a moratorium is in force with respect to a proposed voluntary arrangement of a chargor. If the chargor is in administration, the administrator has the right to deal with the charged assets as if they were free of the charge, although the holder of the floating charge is given the same priority over assets acquired in substitution for the charged assets.²²⁴ If a CVA moratorium is in place, it is not possible to crystallise the charge nor to restrict the right of the chargor to dispose of the charged assets.²²⁵ In addition, a provision in a floating charge is void if it provides that obtaining a CVA moratorium or doing anything to that end will cause the charge to crystallise, lead to a restriction on the right of the chargor to dispose of charged assets, or be a ground for the appointment of a receiver.²²⁶

14.6.2.2.4 Fourthly, under section 245 of the Insolvency Act 1986 floating charges are subject to an additional ground on which they might be avoided in the event that the chargor goes into winding up or administration, which does not apply to fixed security. Section 245 is addressed in further detail later in this chapter.

14.6.3 The nature of a floating charge

In two early cases, Lord Macnaghten provided explanations as to the nature of a floating charge. In *Governments Stock and Other Securities Investment Co Ltd v Manila Rly Co*²²⁷ he said that:

A floating security is an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying condition in which it happens to be from time to time. It is of the essence of such a charge that it remains dormant until the undertaking charged ceases to be a going concern, or until the person in whose favour the charge is created intervenes.

In *Illingworth v Holdsworth*²²⁸ his Lordship contrasted a specific charge (a fixed security) with a floating charge and said:

A specific charge, I think, is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature,

²²⁴ See para 70 of Sched B1 to the Insolvency Act 1986.

²²⁵ See para 13 of Sched A1 to the Insolvency Act 1986.

²²⁶ See para 43 of Sched A1 to the Insolvency Act 1986.

²²⁷ [1897] AC 81, at 86.

²²⁸ [1904] AC 355, at 358. In the Court of Appeal, the case was called *Re Yorkshire Woolcombers' Association Ltd* [1903] 2 Ch 284, to which further reference is made below.

hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.

14.6.3.1 It is clear from what Lord Macnaghten said in the first of those cases that a floating charge is a present form of security which extends to the assets that come within its compass from time to time;²²⁹ it is not an agreement to give future security.²³⁰ It follows that the receipt of new assets within the charge after the commencement of winding up of the chargor is not invalidated as a new disposition in favour of the chargee by section 127(1) of the Insolvency Act 1986.²³¹

14.6.3.2 What is not very clear from the two statements is the extent of the interest of the chargee prior to crystallisation of the charge, bearing in mind the freedom of the chargor to deal with the assets as if they were free of the charge.²³² In the first of the two passages, Lord Macnaghten appears to be saying that the security can be treated as attaching to the assets that come within its compass from time to time. However, in the second of the two passages quoted above Lord Macnaghten appears to be saying that the charge does not attach to the charged assets until crystallisation, as he says that it does not ‘settle and fasten on’ the assets prior to that point. On some views there is a form of security interest in the charged assets prior to crystallisation (a security interest in the fund) but it is not sufficient to be regarded as having attached to the assets.²³³ On other views, the security interest is attached to individual assets prior to crystallisation although the chargor has a licence to deal free of charge in the ordinary course of business (defeasible fixed charge theory)²³⁴ or the security interest is overreached when disposed in the ordinary course of business (overreaching theory).²³⁵ Both sets of views explain why third parties can acquire rights in the charged assets which are superior to the chargee’s proprietary right and why the chargor is able to deal with the assets as if they were free of the charge and confer entitlements on third parties which may be by way of absolute ownership or otherwise take priority over the interest of the chargee.²³⁶ Views have also been expressed against a proprietary character of the floating charge prior to crystallisation. One view (now considered incorrect) was that a floating charge is merely an agreement to give security.²³⁷ More recently, it has been suggested that the floating charge is right against another person’s right²³⁸ or a power *in rem* to acquire an

²²⁹ See Kay LJ in *Driver v Broad* [1893] 1 QB 744, at 749 and the helpful analysis provided by Helsham CJ in Eq in *Re Margart Pty Ltd* (1985) 9 ACLR 269, at 271–273.

²³⁰ Cf the controversial statement of Lord Scott in *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend CBC* [2001] UKHL 58; [2002] 1 AC 336 [63], to the effect that an agreement to give security in the future, in the event that certain conditions arise, might fall within the description of a ‘floating charge’. This view, it is submitted, is inconsistent with *Re Lind* [1915] 2 Ch 345 (CA) and the view of the floating charge espoused in the text.

²³¹ See *Re Margart Pty Ltd* (1985) 9 ACLR 269.

²³² See further the commentary provided in Chap 13 of WJ Gough, *Company Charges* (2nd edn, 1996).

²³³ See L Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 2013 5th edn) para 4-04.

²³⁴ See S Worthington, ‘Floating Charges: An Alternative Theory’ [1994] CLJ 81.

²³⁵ See R Nolan, ‘Property in a fund’ (2008) 120 LQR 108; D Sheehan, ‘Property in a Fund, Tracing and Unjust Enrichment’ (2010) JoEq 4.

²³⁶ See, for instance, Fletcher Moulton and Buckley LJJ in *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979, at 994 and 999–1002, respectively.

²³⁷ W Gough, *Company Charges* (2nd edn, 1996) 97–101, 341–48.

²³⁸ See B McFarlane, *The Structure of Property Law* (Hart 2008).

interest in the future²³⁹ although in either case it would be enforceable at least against some third parties. Deciding which view is correct involves systemic and theoretical questions about the nature of property and proprietary interests, which are not addressed here. Suffice it to say that a floating charge prior to crystallisation at the very least confers more than a contractual interest and that from a practical perspective an analogy with a fund has thus far worked well to explain this type of security.

14.6.3.3 It is possible to take a floating charge over the whole of a company's undertaking and assets or over only one asset or some part of its assets. It is common, but not necessary for its validity, that the instrument of charge will contain the power for the chargee to appoint a receiver of the charged property,²⁴⁰ or, if the charge, together with any fixed charges, relates to all or substantially all the property of the charger, an administrator.²⁴¹

14.6.3.4 The relationship between the chargor and the chargee, which arises from the contractual agreement between them contained in the charge, governs much of the consequences of the security, including as to the circumstances in which the charge crystallises so that it attaches to the charged assets in the manner just described. This was made clear by Hoffmann J in *Re Brightlife Ltd.*²⁴²

14.6.4 The essential characteristic of a floating charge

The most commonly quoted description of the usual characteristics of a floating charge was that provided by Romer LJ in *Re Yorkshire Woolcombers' Association Ltd.*²⁴³ as follows:

I certainly do not intend to attempt to give an exact definition of the term 'floating charge', nor am I prepared to say that there will not be a floating charge within the meaning of the Act [i.e. Section 14 of the Companies Act 1900], which does not contain all the three characteristics that I am about to mention, but I certainly think that if a charge has the three characteristics that I am about to mention it is a floating charge. (1) If it is a charge on a class of assets of a company present and future; (2) if that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and (3) if you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets I am dealing with.

14.6.4.1 Despite the reticence shown by Romer LJ in providing an exact definition, it was confirmed by the Privy Council in the *Brumark* case and by the House of Lords in *Re Spectrum Plus Ltd.*²⁴⁴ that the essential hallmark or characteristic of a floating charge is the third of the three characteristics that were identified by Romer LJ, namely, the liberty of the chargor to deal with the charged assets in the

²³⁹ See R Stevens, 'Contractual Aspects of Debt Financing' in D Prentice and A Reisberg (eds), *Corporate Finance Law in the UK and the EU* (OUP 2012) 213 at 221-223.

²⁴⁰ See *Re Cimex Tissues Ltd* [1994] BCC 626, at 634-635.

²⁴¹ The inclusion of such a power is one of the ways in which a charge can become a qualifying floating charges under para 14 Sched BI Insolvency Act 1986.

²⁴² [1987] Ch 200, at 212.

²⁴³ [1903] 2 Ch 284, at 295.

²⁴⁴ [2005] UKHL 41, [2005] 2 AC 680.

ordinary course of business until the charge is crystallised.²⁴⁵ As Lord Millett remarked in the *Brumark* case, the first two of the characteristics may typically be found in the case of a floating charge but are not an essential ingredient of such a charge and they may also be present in a fixed charge,²⁴⁶ for instance, in a fixed charge over future property. Furthermore, it is possible to take a floating charge over a declining stock of assets, which is not being replenished. Cases which had been decided before the decisions of the Privy Council and the House of Lords on the basis that all three of the criteria had to be present before there could be a floating charge, and thus that an absence of either or both of the first two criteria meant that the security should be treated as a fixed charge, should now be regarded as having been incorrectly decided.²⁴⁷

14.6.4.2 Taking the decisions in the *Brumark* and *Spectrum Plus* cases together, the consequence is that only if the chargor has been effectively deprived in full and from the outset of the liberty to deal with the charged assets in a proprietary sense, so that the assets have truly been set aside as security for payment of the secured obligations, can it be said that there is a fixed charge. To achieve a fixed charge, the chargee has to be in control of the assets, so that the chargee must consent, within its discretion, to their release from the security before they can be dealt with by the chargor. In practice, the distinction in characterising the nature of the security comes down to a practical factual analysis in relation to the security, the assets concerned, and the means by which they can be exploited. It is also important to ensure that the restrictions from dealing that are contained in the security instrument have been followed through in practice and, to that extent, it is relevant to take into account the conduct of the parties subsequent to the creation of the charge,²⁴⁸ although the precise analysis of why this is relevant is rather problematic. The conduct referred to is post-contractual conduct,²⁴⁹ which is not usually admissible when the court is interpreting a contract, unless it is alleged that the contract is a sham.²⁵⁰ Since a sham involved dishonesty, this is unlikely to be a route taken in many commercial disputes. A more satisfactory analysis is that, where the parties' conduct is not consistent with a charge being fixed, this operates as a variation or waiver.²⁵¹ The label ascribed by the parties to the security, whilst indicating their subjective intention, is not determinative of its nature. The courts' approach is, first, to ascertain the nature and the rights and obligations which the parties intended to grant each other in relation to the assets and, secondly, to categorise the relationship so ascertained as a matter of law.²⁵²

²⁴⁵ See Lord Scott in *Re Spectrum Plus Ltd* [2005] UKHL 41; [2005] 2 AC 680, at [107]–[111].

²⁴⁶ At [13].

²⁴⁷ On this basis, it is submitted with respect that the decisions on this aspect of the Court of Appeal in *Re Atlantic Computer Systems PLC* [1992] Ch 505 and of Vinelott J in *Re Atlantic Medical Ltd* [1992] BCC 653 were incorrect.

²⁴⁸ See Lord Millett in the *Brumark* case at [2001] UKPC 28; [2001] 2 AC 710, at [48] and Lord Walker in *Re Spectrum Plus Ltd* [2005] UKHL 41; [2005] 2 AC 680, at [140].

²⁴⁹ The charge document must be interpreted as at the date of creation, because of section 251 Insolvency Act 1986, which defines a 'floating charge' for the purposes of that Act as 'a charge, which, as created, was a floating charge'.

²⁵⁰ *James Miller & Partners Ltd v Whitworth Street Estates (Manchester) Ltd* [1970] AC 583, HL, 603, 611, 614

²⁵¹ See S Atherton and R Mokal, 'Charges over chattels: issues in the fixed/floating jurisprudence' (2005) 26 Co Law 10 and, for detailed analysis of the arguments, see H Beale, M Bridge, L Gullifer and E Lomnicka, *The Law of Security and Title-Based Financing*, 2nd edn (Oxford: Oxford University Press, 2012) paras 6.115 to 6.119.

²⁵² See Lord Millett in the *Brumark* case at [2001] UKPC 28; [2001] 2 AC 710, at [31]–[32], and Lords Scott and Walker in *Re Spectrum Plus Ltd* [2005] UKHL 41; [2005] 2 AC 680, at [119] and [141],

Furthermore, as Hoffmann J had remarked in *In re Brightlife Ltd*²⁵³ and Millett LJ had also said in *Re Cosslett (Contractors) Ltd*,²⁵⁴ a partial restriction would not be a sufficient deprivation of the chargor's liberty to deal with the assets for there to be a fixed charge. In addition, a third party will only be affected by a partial restriction if, on normal principles, it was aware of the restriction and took its interest with the intention of causing the chargor to breach the restriction.

14.6.5 The liberty to deal

In light of its central importance in determining if security is by way of fixed or floating security, as well as the consequences of such a determination, it is necessary to consider the approach that the courts have taken in considering what is meant by the concept of the liberty to deal or, to describe it more fully, dealing in the ordinary course of business with the charged assets. Transactions that take place within the scope of the liberty to deal will have the effect of conferring on the third party that deals with the chargor either an outright ownership right or otherwise a right in the assets that takes priority over the interest of the chargee.

14.6.5.1 The concept has been given a wide and liberal meaning, bearing in mind the proprietary consequences to third parties which deal with the company in reliance upon its liberty to deal with its assets. It refers to general concepts of carrying on business, not the particular business of the chargor.²⁵⁵ It has been held that an unprecedented or exceptional transaction, in terms of the transactions usually entered into by the chargor, may still be within the ordinary course of business.²⁵⁶ The fact that the directors may exceed their powers or that the transaction might amount to a preference of the chargee does not necessarily mean that it would fall outside what might be considered as being in the ordinary course of business.²⁵⁷ A disposal of a substantial part of the chargor's assets, even by one transaction, may still be regarded as being in the ordinary course of business if it is not done with a view to the permanent cessation of the business.²⁵⁸ However, if it is done with a view to the permanent cessation of the business of the company, that is, the company intends to cease business, it will be outside the ordinary course of business and it will cause the charge to crystallise.²⁵⁹

14.6.5.2 The following types of transaction involving charged assets have been held to fall within the ordinary course of business:

respectively. The application of the rule is illustrated by *The Russell Cooke Trust Co Ltd v Elliott* [2007] EWHC 1443 (Ch), [2007] 2 BCLC 637 and *Re Harmony Care Homes* [2009] EWHC 1961 (Ch), [2010] BCC 358, in each of which it was held that a charge which was described as a floating charge was, nonetheless, a fixed charge because the chargor was effectively prevented by the charge instrument from being able to deal with the charged assets.

²⁵³ [1987] Ch 200, at 209.

²⁵⁴ [1998] Ch 495, at 510.

²⁵⁵ Kay LJ in *Driver v Broad* [1893] QBD 744, at 748–749; *Ashborder BV v Green Gas Power Ltd* [2004] EWHC 1517 (Ch), at [227] (Etherton J).

²⁵⁶ See *Willmot v London Celluloid Co* (1886) 34 ChD 147; *Re Borax Co* [1901] 1 Ch 326.

²⁵⁷ See *Willmot v London Celluloid Co* (1886) 34 ChD 147; *Ashborder BV v Green Gas Power Ltd* [2004] EWHC 1517 (Ch), at [227] (Etherton J); *Bulbinder Singh Sandhu (trading as Isher Fashions UK) v Jet Star Retail Limited (in administration)* [2011] EWCA Civ 459, para 10 (Moore-Bick LJ).

²⁵⁸ See *Re Florence Land and Public Works Co, ex p Moor* (1878) 10 Ch D 530; *Hubbuck v Helms* (1857) 56 LJ Ch 536; *Re Borax Co* [1901] 1 Ch 326.

²⁵⁹ See *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366; *Re Real Meat Co Ltd* [1996] BCC 254.

- (1) disposals of assets whilst trading,²⁶⁰ even if it is a quick sale to raise cash,²⁶¹
- (2) use of the proceeds of sale of assets to meet the expenses of the business;²⁶²
- (3) the creation of rights of set-off, either arising as legal set-offs or equitable set-offs;²⁶³
- (4) a sale and lease-back of assets;²⁶⁴
- (5) the grant of fixed security over the assets;²⁶⁵ and
- (6) the grant of a limited floating charge,²⁶⁶ but the grant of a general floating charge is not in the ordinary course of business.²⁶⁷

14.6.6 Fixed v floating security in the context of particular transactions

It is relevant to consider what conditions or requirements may have to be fulfilled, in any particular case, so that the creditor can be sure that it has taken fixed security. This is particularly important if one takes into account the comparative advantages to a creditor of holding fixed security, as opposed to floating security. The question has arisen most strikingly in relation to security over book debts, but it could also arise in many other instances.

14.6.6.1 In theory, it should be possible to take fixed security over any asset,²⁶⁸ but to achieve fixed security, the chargee has to be in control of the charged assets. It is not enough that the chargor has been deprived of control in its own right as, for instance, where the charged assets are subject to an external restriction, where control has been vested in a third party, or where there is joint control between the chargor and chargee.²⁶⁹ It is submitted that it is similarly not sufficient if another creditor already holding a charge is in control, so that a creditor seeking to take a charge in assets in which a fixed charge already exists cannot take a second fixed charge relying on the first chargee's control. It is also submitted that if, on the other hand, the second chargee purports to exercise control over the already charged assets the (second) charge can be fixed even if assets are in control of the first chargee so long as the control exercised by the second chargee is separate from the control exercised by the first chargee. Control in this sense means that the chargee must be in the position that the assets can only be dealt with by the chargor if they have been released from the

²⁶⁰ *Re Florence Land and Public Works Co, ex p Moor* (1878) 10 Ch D 530.

²⁶¹ *Hamer v London, City & Midland Bank Ltd* (1918) 87 LJKB 973.

²⁶² *Re Panama, New Zealand and Australian Royal Mail Co* (1870) 5 Ch App 318.

²⁶³ *Biggerstaff v Rowatt's Wharf Ltd* [1896] 2 Ch 93; *Edward Nelson & Co Ltd v Faber & Co* [1903] 2 KB 367; *Rother Iron Works Ltd v Canterbury Precision Engineers Ltd* [1974] QB 1. The right of a third party to set-off a liquidated cross-claim that it has against the chargor will cease with respect to cross-claims that arise after the third party has received notice that the charge has crystallised: *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 1 WLR 578.

²⁶⁴ *Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* (1984) 8 ACLR 422.

²⁶⁵ *Re Castell and Brown Ltd* [1898] 1 Ch 315; *Re Benjamin Cope & Sons Ltd* [1914] 1 Ch 800.

²⁶⁶ *Re Automatic Bottle Makers* [1926] Ch 412.

²⁶⁷ *Re Benjamin Cope & Sons Ltd* [1914] 1 Ch 800. It would appear that this point was overlooked by Morritt J in *Griffiths v Yorkshire Bank PLC* [1994] 1 WLR 1427.

²⁶⁸ A point that had initially been recognised by Slade J in *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142.

²⁶⁹ See, for instance, *Re ASRS Establishment Ltd* [2000] 2 BCLC 631, in which the Court of Appeal held that there could not be a fixed charge over the benefit of a bank account where, vis-à-vis the chargee, the chargor would have access to the relevant account, which was maintained with a third party, even though there were restrictions inherent in the nature of the account which precluded the company from unrestricted dealing with the account.

security with the consent of the chargee, which it should be at liberty to grant within its discretion on a case-by-case basis. Thus, a standing arrangement or understanding that assets will be released from the charge (with or without meeting certain requirements) will result in the security being in the nature of a floating charge rather than by way of fixed security. For a charge to be fixed the chargee cannot be compelled to provide consent.²⁷⁰ This probably means either that the chargee ought to be completely free whether to give consent or not, or, at the very least, the agreement can only provide that consent cannot be refused capriciously, or unreasonably.²⁷¹ It must also be borne in mind that the question cannot be resolved simply by looking at the title in the asset, without also considering the constituent elements of the asset and its practical or commercial utility. Nor is the answer dictated by the label or form of the security²⁷²; thus, a security which calls itself a legal mortgage or a fixed charge might turn out to be no more than a floating charge when it has been subjected to proper scrutiny.²⁷³ The distinction in characterising the nature of the security will often come down to a factual analysis of the assets concerned, taking into account the true nature of the assets and the means by which they can be exploited and realised in a practical sense. Where the charge document is drafted to cover a list of assets within a single charge and there is no express power to dispose conferred in the agreement but most of the assets are such that are normally disposed in the ordinary course of business then a power to dispose will be implied in relation to all assets in the list. This is because it is thought that parties intend all assets to be treated in the same way: if the parties intended for any assets to be dealt with differently, they would have included a separate clause in the agreement.²⁷⁴

²⁷⁰ See *Gray v G-T-P Group Ltd* [2010] EWHC 1772 (Ch), [2011] BCC 86 where a charge was held to be floating in circumstances in which a chargee, who held the assets, was obliged to transfer the assets without having a right to refuse to do so. *Gray* casts doubt on the case of *Queen's Moat Houses plc v Capita IRG Trustees Ltd* [2004] EWHC 868 (Ch), [2005] BCC 347 where the chargor's right unilaterally to require a chargee to release property from a charge was held consistent with a fixed charge (in that case a floating charge was thought to be a charge in which the chargor can deal with assets without "a reference to" those chargee, which is, it is submitted, different from ability to deal without consent by the chargee).

²⁷¹ 'Unreasonableness' in relation to refusal of consent is likely to be in the sense referred to in cases such as *Commercial First Business Ltd v Atkins* [2012] EWHC 4388 (Ch) and *International Drilling Fluids Ltd v Louisville Investments (Uxbridge) Ltd* [1986] 1 Ch 513, 519–521 discussed below 14.17.1.3.

²⁷² See discussion above 14.6.4.2

²⁷³ It was on this issue that it is respectfully submitted that Slade J fell into error in *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142. He concluded that the necessary element of control over the proceeds of the collections of the charged book debts could be assumed to be in favour of the chargee because the parties had intended that the security should be by way of fixed charge. To put it colloquially, he put the cart before the horse. For criticism of the approach in *Siebe Gorman*, see *Re Spectrum Plus Ltd* [2005] UKHL 41; [2005] 2 AC 680, in particular see Lord Nicholls at para [1] (stating that he agreed the decision in *Siebe* was wrong and should be overruled), Lord Hope at paras [57], [64] and [75] (stating that the decision in *Siebe* was impossible to come to in that case and not defensible "on any rational basis"), Lady Hale at para [162] (stating that *Siebe* should be overruled), Lord Scott at paras [110]-[120] (dismissing the approach in *Siebe*) and Lord Walker at paras [154]-[155] (also seems to disapprove of *Siebe* but in a more cautious way, similarly to Lord Scott).

²⁷⁴ *Re GE Tunbridge Ltd* [1995] 1 BCLC 34, [1994] BCC 563; see also H Beale, M Bridge, L Gullifer, E Lomnicka, *The Law of Finance and Title-based Financing* (Oxford University Press 2nd edn 2012) para 6.103.

14.6.6.2 Book debts (receivables)

Both the *Brumark* and the *Spectrum Plus* cases involved attempts to take fixed security over the present and future book debts of the chargor.²⁷⁵ What follows applies the approach that was taken in those cases.

14.6.6.2.1 The essential nature of book debts as assets, in a practical and economic sense, rests in the ability to turn them into cash proceeds and to use such proceeds. This can be achieved by selling the debts or by getting in payment of the debts. That has to be borne in mind in characterising the nature of security over book debts and the necessity to take control of the debts and the practical utility that they represent. In both the *Brumark* case and the *Spectrum Plus* case it was said that it was not sufficient to draw a line between the debts in their uncollected state and the proceeds of their collection.²⁷⁶ To achieve a fixed charge, the chargor has to be deprived from the outset of both the power to dispose of the debts before collection and the effective use of their proceeds after collection. The deprivation has to be enforced from the very beginning of the security. It matters not whether one views the book debts and their proceeds of collection as two separate assets or that one is the emanation of the other. In reality, the proceeds of collection are ‘merely the traceable proceeds of the [debt] and represent its entire value’.²⁷⁷ It makes no commercial sense to treat them separately, in the sense of attempting to isolate the debts from their proceeds of collection. What follows will assume that the chargor has been precluded from dealing with the book debts prior to their collection. It will concentrate on how the collection should be achieved and what should be done with the proceeds of the collection.

14.6.6.2.2 Where the chargee is a bank and is able to provide an account which the chargor can use to receive collections of the book debts, it is possible to achieve a fixed charge by requiring the chargor to collect payment of the debts through the account. However, it is not sufficient merely to provide that the chargor is obliged to collect the debts by paying them into its account with the chargee, if the chargor may then have effective use of the proceeds of collection by drawing on the account into which they had been paid.²⁷⁸ Thus, in a case where the proceeds are paid into an overdrawn account, if that goes towards restoring the overdraft limit in consequence of which the chargor could make further withdrawals from the account, then there would not be an effective or practical limit to the chargor’s ability to use the proceeds of collection. It follows that the proceeds must be paid into a blocked account to which the chargor is denied access, so that the balance on the account may only be released to the chargor on a case-by-case basis. The facts must substantiate that the account is blocked in practice and not just in theory. Hence, it is insufficient that the chargee simply reserves the right to block the account in the future. The necessary procedures can be achieved by using the model in the Irish case of *In re Keenan Bros Ltd*.²⁷⁹ In that case, the chargor was obliged to pay its collected debts into a blocked account at the chargee bank. The bank retained complete discretion and day-to-day control over withdrawals from that account, which could only be made with prior

²⁷⁵ A number of other cases also involved the same issue, including *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd’s Rep 142 and *Re New Bullas Trading Ltd* [1994] 1 BCLC 485.

²⁷⁶ As had been done erroneously by the Court of Appeal in those cases

²⁷⁷ Per Lord Millett in the *Brumark* case at [2001] UKPC 28; [2001] 2 AC 710, at [46].

²⁷⁸ Which had been the view taken by Slade J in *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd’s Rep 142.

²⁷⁹ [1986] BCLC 242.

written consent. *Keenan Bros* was referred to with approval in both the *Brumark* case and the *Spectrum Plus* case.

14.6.6.2.3 An alternative method would be for the debts to be assigned by way of mortgage to the financier from the outset, with notice of the assignment being given to the debtors, such that the debtors would be directed to make payment directly to the financier. The financier would then collect payment itself and retain the proceeds as security or use them in discharge of the secured liabilities.²⁸⁰ As Lord Millett pointed out in the *Brumark* case, this structure may not be commercially practical, unless the financier was able to undertake the administrative work of receiving and processing the payments.²⁸¹ It is, however, a model sometimes used in receivables financing.

14.6.6.2.4 A further alternative, which might be useful if the financier is not a bank, is that there would be an unnotified equitable assignment by way of mortgage of the debts. The assignor (i.e. the financier's customer) would declare itself to be the trustee of the financier for the purpose of collecting the debts, having been given the authority of the financier to do so on behalf of the financier. The assignor would be required to open a separate account at a bank into which the debts would be collected. The account would itself also be subject to a trust in favour of the financier, with notice given to the bank of the security. It would be necessary that all concerned should agree that no withdrawal could be made from the account without the financier's consent. Again, this model is often used in receivables financing, as an alternative to an absolute assignment under a whole turnover agreement.²⁸²

14.6.6.2.5 Whichever of the above methods is used, it is bound to be rather cumbersome. It is also unlikely to appeal to the chargor/assignor when borrowing from a bank under an all assets debenture, because the chargor/assignor will not have ready access to the proceeds of collection of the book debts and so will be denied the economic use of the proceeds of collection of its receivables. Therein, of course, lies the basis of the decisions by the Privy Council and the House of Lords. In asset-based lending, where the financier is lending against specific assets (here, the company's receivables) this is not so much of an issue.

14.6.6.2.6 Thus, in a receivables financing transaction, the financier will usually enter into a debt purchase transaction with its customer, such as a factoring, invoice discounting, or block discounting transaction. Such transactions involve the purchase by the financier of the customer's book debts and do not have to give way to the claims of a liquidator for liquidation expenses or the claims of the preferential creditors in an insolvency of the customer, nor will they suffer from the depredations inflicted on the realisations of assets subject to a floating charge pursuant to section 176A of the Insolvency Act 1986. In *Lloyds & Scottish Finance Ltd v Cyril Lord Carpets Sales Ltd*²⁸³ the House of Lords held that the invoice discounting arrangement in that case was to be regarded as a purchase of the relevant debts, rather than a loan with security. As such, it did not constitute a registrable charge within the equivalent

²⁸⁰ This alternative, and the one that is next mentioned, were canvassed briefly by Lord Hope in *Re Spectrum Plus Ltd* [2005] UKHL 41; [2005] 2 AC 680, [54]. See also Lord Millett in the *Brumark* case at [2001] UKPC 28; [2001] 2 AC 710, [17].

²⁸¹ Per Lord Millett in the *Brumark* case at [2001] UKPC 28; [2001] 2 AC 710, at [17].

²⁸² This model has the advantage that the fixed charge is registrable, so that the financier can give notice of it to those who might take an interest in the debts, while an absolute assignment made by a company is not registrable. For suggestions for reform, see Chapter 17.

²⁸³ [1992] BCLC 609.

in Northern Ireland of section 859A of the Companies Act 2006.²⁸⁴ Even where receivables financing is effected by the purchase of debts, as described in this paragraph, the financier will typically take a (registrable) fixed charge over ‘non-vesting’ debts.²⁸⁵

14.6.6.3 Other assets

Although the decisions in *Spectrum Plus* and *Agnew* were specifically concerned with transactions involving book debts or receivables, they have a wider implication, particularly in the emphasis that they place on three matters in distinguishing fixed from floating security. First, that the crucial matter in determining the character of the security lies in whether or not the chargee is in control of the assets so that the chargor has been fully deprived of the liberty to deal with the assets. Secondly, that the first two of the characteristics mentioned by Romer LJ in the *Yorkshire Woolcombers* case are not defining criteria, so that their presence or absence will not be conclusive. Hence, it is possible that a floating charge may be taken over a single or itemised asset or assets and such a charge may exist over a diminishing number of assets which may not be replenished. Thirdly, that it will not be sufficient to judge the first issue by looking at a particular asset in isolation and removed from its practical nature and utility, as well as its effective exploitation as an asset.

14.6.6.4 Plant and equipment

If it is wished to take fixed security over items of plant and equipment or similar types of ‘fixed asset’ (as described in accounting terms), it is suggested that it would not be safe to rely on cases²⁸⁶ where it was held that if the charge covered specific plant or equipment which was itemised (or otherwise identified) in the security document then that was a sufficient indication of an intention to grant fixed security to be determinative, even though the chargor was given a limited licence to dispose of the assets, for instance if they were to be replaced. In *Re Cosslett (Contractors) Ltd*,²⁸⁷ which was a case concerning equipment, Millett LJ had emphasised the importance of the control test as to dealings with the relevant equipment, that is, control in the hands of the chargee. On this basis, a fixed charge can only be taken if the chargor is precluded from disposing of the asset (in the sense of disposing of it or granting proprietary entitlements in it) without the permission of the chargee.²⁸⁸ In this regard, it is relevant that quite a lot of computer and other electronic equipment has a

²⁸⁴ Formerly s 860 of the Companies Act 2006.

²⁸⁵ These are debts which contain a clause restricting assignment. In some circumstances such clauses will no longer be enforceable if the draft Business Contract Terms (Restrictions on Assignment of Receivables) Regulations are enacted, see 14.1.9.2.

²⁸⁶ Such as *National Provincial Bank of England Ltd v United Electric Theatres Ltd* [1916] 1 Ch 132 and *Re Cimex Tissues Ltd* [1994] BCC 626. Although the latter case referred to *Holroyd v Marshall* (1862) 10 HL Cas 191 as an early authority for the view that it was consistent with a fixed charge that the chargor might have a limited licence to dispose of charge assets, it is submitted that the House of Lords in that case did not have this particular point in mind (after all, *Re Panama New Zealand and Australian Royal Mail Co* (1870) LR 5 Ch App 318, which came some years later, is generally regarded as the first case in which the concept of the floating charge was recognised). Furthermore, the grantor of the bill of sale in *Holroyd v Marshall* was an individual trader and not an incorporated entity.

²⁸⁷ [1998] Ch 495 (affd at [2001] UKHL 58, [2002] 1 AC 336).

²⁸⁸ The one possible qualification to this could be that the chargor might safely be given a licence to dispose of equipment once it has reached a state of such longevity that it has no value, provided that adequate precautions are in place to demonstrate that fact before a disposal takes place. This would be because the chargee would not be affected in a practical sense by such a disposition.

relatively short life before it falls due for replacement and so it looks more like circulating assets than long-term permanent or semi-permanent assets, which adds further necessity to the requirement for control in the hands of the chargee.²⁸⁹ It is also submitted that the chargor should be precluded from entering into other types of dealing in the asset, by way of bailment, which may affect, in a substantial sense, the entitlement to take possession of the asset or the long-term value of the asset. On the other hand, a permission that is given to the chargor to grant bailments at will, which can be immediately terminated, or relatively short-term periodic bailments, should not affect the nature of the security, because they do not threaten the chargee's interest to any material extent.

14.6.6.5 Equipment leases or hire purchase transactions and rental payable under them

One issue which remains outstanding in relation to the characterization of charges as fixed or floating, is to determine, in any given fact situation, over what assets the charge needs to exercise control for the charge to be fixed. For example, in the case of a charge over a debt, the proceeds generated when the debt is paid are seen as part of the 'charged assets'. However, a piece of machinery may produce widgets which are of value, yet it is not necessary for the chargee to control the widgets for there to be a valid fixed charge over the machinery (providing the machinery itself is controlled). The difficulty is to isolate the precise criteria on which to draw the line between these two extremes. It is suggested that there are three relevant factors. The first is how directly the asset generates the income.²⁹⁰ The second is how close the generation of income comes to being the sole value of the asset, and the third is whether the asset is destroyed by the generation of income.²⁹¹

The application of this analysis, and of the decisions in the *Brumark* case and the *Spectrum Plus* case to the earlier decisions in *Re Atlantic Computer Systems plc*²⁹² and in *Re Atlantic Medical Ltd*,²⁹³ leave the status of the latter cases in great doubt, particularly in relation to the charge over rentals under the security in those cases. In the *Atlantic Computers* case, the company was in the business of leasing equipment to end users. It obtained finance for the cost of its acquisition of the equipment through entering, as hirer, into a hire purchase agreement or, as lessee, into a leasing agreement of the equipment, which it had already agreed to sub-hire or sub-lease to the end users. As security for the performance of its own obligations, it had given security to the financier over the benefit of the sub-leases, including the rentals payable to it thereunder. The subleases were identified in a schedule to the security. There was no contractual restriction as to the collection or use of such rentals by the company, at least prior to enforcement, and whilst the court noted that there was no specific permission given to the company as to the exercise by it of its rights under the sub-leases, there would appear to have been no specific conferral of control over those rights in favour of the chargee. The Court of Appeal held, nonetheless, that the

²⁸⁹ See the approach taken in *Re GE Tunbridge Ltd* [1994] BCC 563.

²⁹⁰ In the case of the piece of machinery referred to in the text, the number of steps that have to be gone through before the widget and the income from it is generated means that control of the widget or the income is not necessary for a fixed charge over the equipment.

²⁹¹ See H Beale, M Bridge, L Gullifer and E Lomnicka, *The Law of Security and Title-Based Financing*, (2nd edn, Oxford: Oxford University Press, 2012) 6.130 for a more detailed discussion.

²⁹² [1992] Ch 505.

²⁹³ [1992] BCC 653.

company had given fixed security over both the sub-leases and the rental payable thereunder because the relevant assets were in existence and identified when the security was given and should therefore be distinguished from a floating charge where the charge was ambulatory and covered present and future assets. This analysis draws upon the first two of Romer LJ's characteristics in the *Yorkshire Woolcombers* case,²⁹⁴ whilst saying little in relation to the third of those characteristics. The court noted specifically that its decision was not affected by the fact that the company had unrestricted access to the rentals and the use of their proceeds.

14.6.6.5.1 The position was almost the same in the *Atlantic Medical* case, except that the security extended to cover any future leases of the equipment and the rentals payable under such leases. Vinelott J followed the Court of Appeal in the *Atlantic Computers* case and held that the extension of the security to cover the future subleases was not material as they would be in replacement of the identified existing sub-leases and therefore amounted to much the same thing. He also held that it was not realistic to distinguish, for security purposes, between the sub-leases and the rentals payable under them, as in taking security over the benefit of the subleases the security would also attach to the rentals. The two were inextricably linked.

14.6.6.5.2²⁹⁵ Applying the analysis in 14.6.6.5 to these two cases shows that, in both cases, the rentals were part of the 'charged assets' so that lack of control over them should render the charges floating. First, the lease generates the income without the need for any act on the part of the chargor except to collect in the income, making the situation comparable to receivables, and different from, for example, assets which generate income by being sold. Second, to the lessor of chattels, the whole value of the lease is in the rentals generated. Third, although the payment of rentals does not immediately destroy the lease, this happens once the last rental is paid and the term expires. Although this could be said to be a point of distinction from the receivables situation, this would mean that all contracts under which payment was due in installments would fall within this category, even where the chargor had total freedom to use the sums paid. This would give an odd distinction between receivables payable on one occasion and on a number of future occasions.²⁹⁶

14.6.6.6 Insurance policies

The necessity of establishing control in the hands of the chargee will apply to situations where it is desired to take fixed security over an insurance or assurance policy and any claim or proceeds of a claim made under the policy. This requirement was found to have been met in *Re CCG International Enterprises Ltd*,²⁹⁷ where the charge required the chargor to take out and maintain the relevant policy and that the proceeds of any claim should, at the option of the chargee, be paid to the chargee or

²⁹⁴ [1903] 2 Ch 284.

²⁹⁵ For more detailed argument, see H Beale, M Bridge, L Gullifer and E Lomnicka, *The Law of Security and Title-Based Financing*, (2nd edn Oxford: Oxford University Press, 2012), paras 6.133 – 6.135.

²⁹⁶ See S Worthington, 'Floating Charges: the use and abuse of doctrinal analysis' in J Getzler and J Payne (eds), *Company Charges: Spectrum and Beyond* (2006) 34, F Oditah, 'Fixed charge over book debts after Brumark' (2001) 14 *Insolv Int* 49, 54 and F Oditah, 'Recurrent Issues in Receivables Financing' in J Armour and J Payne (eds) *Rationality in Company Law: Essays in Honour of DD Prentice* (2009) 339- 340.

²⁹⁷ [1993] BCC 580.

applied in re-instatement of the damaged property to which the claim related. The chargee was in control and could decide how it wished the proceeds of the claim to be applied. It would have been different if that option had rested in the chargor. It is not uncommon to find situations where the chargor is given such an option with respect to the proceeds of claims, either altogether or up to certain monetary levels. It is submitted that such situations would result in there being only a floating charge over the policy and claims under it, even in cases where the total claim exceeded the stipulated level, because the claim is one chose in action and indivisible. In line with the *Brumark* case and the *Spectrum Plus* case, the chargee must be in control of the policy and claims made and payable under it, if it wishes to take fixed security, including both its uncollected state and its proceeds of collection or recovery.²⁹⁸

14.6.6.7 Shares in a company

A question arises about characterisation of a charge over shares owned by a company who does not deal in shares, which is relevant where the charge falls outside the Financial Collateral Arrangements (No 2) Regulations. In particular, the issue that arises is whether dealings in the dividends are relevant to the characterisation of the charge.

14.6.6.7.1 One view might be that, analogously to a charge over book debts, a charge cannot be fixed without the chargee taking control over the dividends.²⁹⁹ However, a better view is that the ability of the chargor to exercise the rights of receiving dividends does not render the charge floating. This is supported by the decision in *Arthur D Little (in administration) Ltd v Ableco Finance LLC*.³⁰⁰ In that case the terms of the charge were such that the company was not free to dispose of the shares without the chargee's consent but could use the dividend and redemption moneys in the ordinary course of business. The charge over shares was held to be a fixed charge. The correct analogy is therefore with a tree and fruit, not with book debts.³⁰¹

14.6.6.7.2 Shares encompass not only rights to receive dividends, either by way of the distribution of income or of capital, but also rights to vote as a shareholder, and to require that the affairs of the company are properly conducted in accordance with the memorandum and articles of association.³⁰² Insofar as voting rights are concerned, it would be unfortunate if the secured creditor taking a fixed charge would be required to take 'control' over voting rights. Such a position would give rise to practical problems. For example, the security holder could find that the company will

²⁹⁸ There must be a query, in this regard, as to the effect of s 83 of the Fires Prevention (Metropolis) Act 1774, which provides that the proceeds of any claim arising from a fire causing damage to a building shall be applied in re-instatement and repair of the building, if so requested by any person interested in the building. This must detract from the chargee's control as to the application of such proceeds.

²⁹⁹ This was the view expressed in the previous edition that effective fixed security could not be taken without the control of those rights being surrendered to (or at least under the control of) the chargee and so, the view expressed there was that simply preventing dealings with the title in the shares, without also taking account of those other aspects within the scope and coverage of the security, was insufficient to constitute fixed security over the shares. For those reasons, it was thought that the decision in *Arthur D Little Ltd v Ableco Finance LLC* [2002] EWHC 701 (Ch), [2003] Ch 217 was wrongly decided.

³⁰⁰ [2002] EWHC 701 (Ch), [2003] Ch 217.

³⁰¹ See H Beale, M Bridge, L Gullifer and E Lomnicka, *The Law of Security and Title-Based Financing*, (Oxford: Oxford University Press, 2012, 2nd edn) para 6.136.

³⁰² See *Cambridge Gas Transport Corp v The Official Committee of Unsecured Creditors of Navigator Holdings PLC* [2006] UKPC 26; [2007] 1 AC 508, at [26] referring to Farwell J in *Borland's Trustee v Steel Brothers* [1901] 1 Ch 279, 288.

be treated as being its 'subsidiary'³⁰³ or 'subsidiary undertaking'.³⁰⁴ Although such risk could be overcome by providing that, prior to enforcement of the security or except to preserve its value, the relevant rights are held for, and are exercisable for the benefit of, the giver of the security³⁰⁵ but this would have to be outside security to avoid the risk of recharacterisation. It seems that a much simpler solution would be to say that a charge is fixed without taking control over rights attached to shares.

14.6.6.8 Contractual rights

If fixed security is to be taken over other types of intangible rights, such as contractual rights, the chargee should ensure that the chargor cannot deal with those rights and this may extend to their constituent elements without the chargee's consent. The scarcity of case law and detailed guidance in this area has led some to take a cautious approach in practice which ensures that the chargee is fully entitled to receive and control the fruits or the proceeds of those rights and other entitlements relating to them.

14.6.6.9 Intellectual property

There may also be difficulties associated with taking fixed security over intellectual property, particularly if the chargor is permitted to continue in the exploitation of the rights concerned, such as by granting licences to third parties or, indeed, if the structure requires that an exclusive licence back should be granted to the giver of the security by the party taking the security.³⁰⁶ An exclusive licence will usually be granted where the security has taken the form of an absolute or legal assignment by way of mortgage of the rights concerned, such a mortgage having the consequence that the legal title in the rights is vested in the mortgagee. That may have the effect of depriving the mortgagor of the right to assert the rights in infringement proceedings and to deal with them by granting licences, unless the mortgagee joins in the proceedings and in the granting of licences. To avoid such difficulties, the mortgagee may grant an exclusive licence to the mortgagor for the period of the security or, at least, until its enforcement.

14.6.6.9.1 From a security perspective, however, the granting of an exclusive licence may have unfortunate consequences in terms of ascertaining whether only a floating charge has been granted. This is because an exclusive licence has the effect that the licensee is granted the exclusive right to exploit the licensed rights to the exclusion of the licensor during the period of the licence. Even where there is not a requirement for the grant of an exclusive licence, such as where the security is by way of equitable mortgage or charge, if the security giver is permitted to carry on with the exploitation of the relevant rights as if it were the owner of them then there is a real

³⁰³ See s 1159 of the Companies Act 2006.

³⁰⁴ See s 1162 of the Companies Act 2006.

³⁰⁵ See para 7 of Sched 6, and para 8 of Sched 7, to the Companies Act 2006 (formerly s 736A(7) of, and para 8 of Sched 10A to, the Companies Act 1985).

³⁰⁶ As is likely to be the case where the security takes the form of an assignment of the relevant intellectual property. An exclusive licence will usually be granted back to enable the assignor/mortgagor to continue using and exploiting the rights and to enable it to take proceedings in defence of the rights.

risk that the security may be characterised as only being by way of a floating charge.³⁰⁷

14.6.6.10 Real property

Given its permanent and enduring nature, the ownership of real property (whether it be a freehold or a leasehold interest) is a prized form of ownership under English law and, accordingly, such an asset should be a suitable subject over which fixed security may be taken. However, commercial, farming, and other types of investment property is often leased out on leases of varying length and, indeed, a tenant under a lease is recognised as capable of having a legal estate in land which is separate and distinct from the estate in fee simple.³⁰⁸ A sub-lease has the same consequences with respect to the head lease out of which it has been granted. Section 99 of the Law of Property Act 1925 expressly recognises and authorises the power of a mortgagor to grant leases (or sub-leases) for substantial periods, subject to any contrary provision in the mortgage instrument. With that in mind, it is not uncommon to find in a mortgage of an interest in land (strictly speaking, such an instrument is called a legal charge) where the interest is not held for investment purposes (investment purposes in this sense principally comprising the granting of leases) to find that the security document forbids the mortgagor from granting leases, no doubt because a lease of any substantial period would have a detrimental effect on the value of the reversionary interest.

14.6.6.10.1 A question must therefore arise as to the effect on a mortgagee's security where the mortgagor has the right to enter into leases or sub-leases or, indeed, licences, except where the tenant or licensee can be dispossessed of its occupation quickly and without difficulty. Whilst in theory the freehold or leasehold interest of the grantor of the lease or licence is separate from the interest that arises under the lease or the right of occupation under the licence, the practical or economic effect of a lease or licence upon the value of the grantor's reversion could be substantial. The difficulty arises most acutely where the interest that is to be mortgaged is held for investment purposes, because the whole reason why the mortgagor as owner holds its interest is to rent it out and derive an income from it. Indeed, a substantial part of the value of the interest may lie in its suitability to be used for that purpose.

14.6.6.10.2 It is submitted that the answer to the dilemma may be found in the point that has just been made, bearing in mind that the question must be examined by considering where the practical value and utility of the asset lies. The point of holding investment property is that the asset should be exploited by entering into leases. If, by so doing, the value of the holding is preserved or even enhanced, rather than diminished, then the legal estate of the mortgagor over which the security is taken should be recognised as a valuable asset in itself, which is not imperilled by the granting of leases. On the other hand, if the grant of a lease means that the value of the reversionary interest is undermined (for instance, because the grant is for such a long period that, as a result of the grant, there would be little value left in the reversion) then that should be a matter that needs to be controlled by the mortgagee so that it can be confident that it has a fixed security interest. The cautious approach,

³⁰⁷ The position described in these two paragraphs is unfortunate as it makes it difficult for small businesses to obtain loan finance on the security of intellectual property: the lender does not want to lend on the security of merely a floating charge, but the borrower does not want to lose its right to exploit the intellectual property, since that is a vital part of the income of the business.

³⁰⁸ See s 1 of the Law of Property Act 1925.

however, would be to prevent the mortgagor from having the right to grant leases or licences without the mortgagee's consent, with the mortgagor having to rely upon the mortgagee to take a common-sense approach in deciding if it will grant consent when an application is made to it for consent.

14.6.7 Crystallisation

The right of the chargor to deal with the charged assets under a floating charge continues until such time as the right to do so is taken away. At that point, the charge is said to 'crystallise', when it becomes a fixed charge with respect to the assets then or thereafter within its compass.³⁰⁹ This is also called the process of 'crystallisation'. The consequence is that the chargor is no longer authorised to deal with the charged assets. If the security is comprehensive this has the practical effect that the chargor can no longer carry on its business.

14.6.7.1 *The circumstances in which crystallisation may occur*

In principle, a floating charge will crystallise in accordance with the terms of the agreement contained in the charge, which will be those implied by law in consequence of that agreement (unless inconsistent with the express terms of that agreement³¹⁰), together with any additional grounds that may have been specifically agreed.³¹¹

14.6.7.1.1 The grounds that are implied by law are as follows. First, the winding up of the chargor, whether it is a compulsory winding up or a solvent or insolvent voluntary winding up.³¹² It is the making of the winding-up order or the passing of the resolution to wind up which causes the charge to crystallise on this ground, not action preliminary thereto.³¹³ Secondly, the appointment by the chargor of a receiver and other action to enforce the security.³¹⁴ It should be noted that the appointment of a receiver by another creditor will not cause the charge to crystallise unless it also provides another of the grounds for the charge to crystallise.³¹⁵ Thirdly, the company permanently ceasing to carry on business, to the extent not already encompassed within the other two grounds.³¹⁶ A company will not necessarily cease its business simply because another creditor takes enforcement action, such as by appointing a receiver or because an administrator has been appointed. The receiver (if he has power to do so) or administrator may decide to continue the business.³¹⁷

³⁰⁹ *NW Robbie & Co Ltd v Witney Warehouse Co Ltd* [1963] 1 WLR 1324; *Re The Real Meat Co Ltd* [1996] BCC 254.

³¹⁰ There must be an overt and real inconsistency. The implied grounds will not be treated as overridden simply because there are also express terms which do not also contain the grounds that would be implied: see *Re The Real Meat Co Ltd* [1996] BCC 254, at 261.

³¹¹ *Re Brightlife Ltd* [1987] Ch 200.

³¹² *Re Panama New Zealand and Australian Royal Mail Co* (1870) LR 5 Ch App 318; *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979; *Re Crompton & Co. Ltd* [1914] 1 Ch 954.

³¹³ *Re Victoria Steamboats Co* [1897] 1 Ch 158; *Stein v Saywell* (1969) 121 CLR 529.

³¹⁴ *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979.

³¹⁵ *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366; *Re The Real Meat Co Ltd* [1996] BCC 254.

³¹⁶ *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366; *Re The Real Meat Co Ltd* [1996] BCC 254.

³¹⁷ *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366; *Re The Real Meat Co Ltd* [1996] BCC 254.

14.6.7.1.2 It is now clear that a charge will also crystallise on any additional grounds that are specified in the charge, such as pursuant to events of default-type provisions.³¹⁸ The charge may require that the chargee should give notice to the chargor that the charge has crystallised following upon the occurrence of such an event, or it may provide, just as effectively, that the charge will crystallise automatically.³¹⁹

14.6.7.1.3 Obviously, an automatic crystallisation clause is not in the interests of the chargor, which should resist the inclusion of such a clause in the charging instrument. An automatic crystallisation clause does not advance the interests of the chargee as against creditors that enjoy a statutory right of priority against the chargee, because those rights apply even if the charge has crystallised. Nonetheless, it may be helpful in defeating the claim of an execution creditor,³²⁰ and it may also prevent the chargor from disposing of charged assets to the detriment of the chargee. Care should be taken, however, in being overzealous in the drafting of an automatic crystallisation clause. This is because of the risk that the charge might crystallise on obscure grounds without the chargee realising that it has done so. That could lead to arguments that the chargee has waived its right to rely on the clause or that it is estopped from doing so. It is best that the clause should be limited, so that it operates to provide protection in situations where the interests of the chargee in charged assets might be at risk of being jeopardised, such as in execution proceedings.

14.6.8 Priorities

It is relevant to consider how the interest of a chargee under a floating charge might fare vis-à-vis the interests of third parties, such as those that enter into transactions with the chargor concerning the charged assets. The discussion as to priorities will be divided into three parts. The first part will describe the position with respect to transactions with third parties that the chargor enters into prior to the crystallisation of a floating charge. The second part will discuss the position where such transactions occur after the charge has crystallised. The third part will address statutory priorities that arise in favour of certain prescribed classes of third parties.

14.6.8.1 It is always open to private parties to enter into a priority agreement, by which they agree as to the ranking of their respective interests, which will override the outcome that would otherwise apply as a matter of general law.³²¹ If they do so, however, they must be mindful of the decision in *Re Portbase Clothing Ltd*,³²² to which reference will be made after the discussion concerning statutory priorities.

14.6.8.2 Transactions that take place before crystallisation

So long as such transactions fall within the inherent authority of the chargor under a floating charge to deal with the charged assets in the ordinary course of business, third parties which take under them will prevail as against the interest of the chargee. If such a third party is an outright purchaser then it will acquire ownership of the asset free of the charge. If it takes fixed security, or a limited second floating charge, its

³¹⁸ *Re Brightlife Ltd* [1987] Ch 200.

³¹⁹ *Re Manurewa Transport Ltd* [1971] NZLR 909; *Re Brightlife Ltd* [1987] Ch 200.

³²⁰ An example can be drawn from *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979, where the execution creditor prevailed against assets that were only subject to an uncrystallised floating charge.

³²¹ *Cheah Theam Swee v Equiticorp Finance Group Ltd* [1992] 1 AC 472.

³²² [1993] Ch 388.

security will rank ahead of the interest of the chargee under the floating charge, including as to the consequences of enforcement of the third party's security. This will be the case even if the third party had notice of the existence of the floating charge, as such notice on its own does not serve to negative the inherent ability of the chargor to deal with the assets as if they were free of the charge.³²³ In similar vein, an execution creditor which completes its execution against the charged assets before the charge crystallises will take free of the charge.³²⁴ Similarly, rights of set-off for claims that have accrued before crystallisation will be enforceable notwithstanding the charge.³²⁵

14.6.8.2.1 There is an important qualification to what has just been said, which concerns the effect of a negative pledge provision in the floating charge.³²⁶ Under such a provision, the chargor will typically undertake in favour of the chargee that the chargor will not enter into certain types of transaction with third parties concerning the charged assets without the prior consent of the chargee. Such transactions are likely to include the granting of security to third parties and other types of transaction, such as receivables sales, that are primarily in the nature of raising finance or which have the effect of reducing the overall value of the charged property. Clearly, such a restriction will have contractual effect as between the chargor and the chargee, but it will not serve to turn the charge into a fixed charge.³²⁷ The important question is the effect that it might have on the validity and enforceability of the interest purportedly acquired by the third party that is concerned in an impugned transaction.

14.6.8.2.2 In answering that question, it must be remembered that the assumption which is inherently associated with a floating charge is that the chargor has the right to deal with the charged assets as if it were the outright owner of them, so long as the transaction is of a type that would fall within the very general concept of the ordinary course of business as it has been interpreted by the case law. A third party which deals with the chargor is generally entitled to rely on that assumption. To assert a remedy against a third party, the chargee must displace the assumption, which will not be an easy burden although the 2013 reform of the law governing charges granted by companies has gone a long way to make the burden lighter. If the third party has taken its interest with notice of the restriction it takes subject to the restriction and therefore to the floating charge,³²⁸ if it takes without notice the interest it takes is free of the effect of the restriction.³²⁹ Prior to the reform it was clear that notice (including constructive notice) of the existence of a security did not give notice of its contents.³³⁰ Since the 2013 reform of company charges, the chargee has now the ability to indicate in the statement of charge particulars, which are filed and registered alongside a copy of the charge instrument, whether the terms of the charge comprise a clause

³²³ *English & Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700; *Re Castell & Brown Ltd* [1898] 1 Ch 315.

³²⁴ *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979.

³²⁵ *Biggerstaff v Rowatt's Wharf Ltd* [1896] 2 Ch 93; *Edward Nelson & Co Ltd v Faber & Co* [1903] 2 KB 367; *Rother Iron Works Ltd v Canterbury Precision Engineers Ltd* [1974] QB 1.

³²⁶ Negative pledges are referred to earlier in this chapter. For a more detailed discussion concerning negative pledges, see Chap 3.

³²⁷ See *Re Brightlife Ltd* [1987] Ch 200.

³²⁸ *English & Scottish Mercantile Investment Co Ltd v Brunton* [1892] 2 QB 700, 707 (Lord Esher MR); *Cox v Dublin City Distillery Co* [1906] IR 446; *Wilson v Kelland* [1910] 2 Ch 306.

³²⁹ *English & Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700.

³³⁰ *Wilson v Kelland* [1910] 2 Ch 306; *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142.

prohibiting or restricting the chargor from creating security which ranks equally with or ahead of the charge. Thus, a person who is considered to have notice of the charge (including constructive notice) based on the registered particulars³³¹ (such as a subsequent chargee) will also have notice (including constructive notice) of a negative pledge clause if one is registered as part of particulars.³³² Thus, assuming the negative pledge clause is included in the registered particulars, it will be easier for the claimant to show that the third party knew of the restriction.

14.6.8.2.3 If a transaction takes place which is outside the ordinary course of business then it will be a question of competing priorities, as between the interest of the chargee and that of the third party taking under the transaction. If the party to the transaction had notice (including constructive notice) of the existence of the floating charge then it is submitted that the interest of such a party would defer to that of the chargee, because that party should be aware that the chargor had no authority to enter into the transaction and, accordingly, that the transaction amounted to a breach of the contractual authority of the chargor. That would certainly be the position if the transaction followed upon a decision to cease business, thereby causing the floating charge to crystallise.³³³

14.6.8.2.4 Priority as between a floating charge and subsequent floating charges depends, it is submitted, on the question of the extent of the chargor's authority to dispose of the asset under the floating charge. For example, in *Re Automatic Bottle Makers Ltd*³³⁴ an instrument created a general floating charge over company's all undertaking and assets both present and future but reserved to the company power to create in priority to that charge over certain property and in the ordinary course of business. A subsequent charge created by the company as a result of the exercise of the power in the agreed manner took priority over the first charge. However, if there had been no agreement with the first floating charge holder a company would not have been in a position to create a second floating charge to have priority to, or to rank *pari passu* with, another floating charge already created.³³⁵ In light of these authorities, it is submitted, with respect, that the conclusion reached by Morritt J in *Griffiths v Yorkshire Bank PLC*³³⁶ was incorrect. It was held in that case that where a second general floating charge crystallised before an earlier floating charge, the interest of the holder of the crystallised charge would have priority over the interest of the holder of the earlier charge, which crystallised later. This was because the second charge had become a fixed charge before the first charge had done so, and thus was to be treated as if it were the first in time. However, an approach consistent with the earlier-mentioned authorities would be to say that the granting of the second general floating charge fell outside the ordinary course of business and so the chargor did not have authority to grant the second general floating charge; nor had the holder of the first charge consented to the granting of the second charge. On that basis, the rights and interest of the holder of the second charge should have been subject to those of

³³¹ It is not clear under current law of what the registration is notice (whether the particulars, the charge instrument or both provide notice) and to whom. For further discussion, see 14.13.

³³² See *English & Scottish Mercantile Investment CO v Brunton* [1892] 2 QB 700, 708-709.

³³³ *Re The Real Meat Co Ltd* [1996] BCC 254. In that case, not only was the purchaser under the transaction affected by knowing that the charge had crystallised but so also was the bank which lent the money to fund the purchaser and took security over the purchased assets for its loan. The consequence was that the holder of the crystallised charge took priority over both the purchaser and the bank.

³³⁴ [1926] Ch 412.

³³⁵ *Re Benjamin Cope & Sons* [1914] 1 Ch 800.

³³⁶ [1994] 1 WLR 1427.

the holder of the first charge and the crystallisation of the second charge should not have affected the outcome.

14.6.8.3 Transactions that take place after crystallisation

Upon crystallisation of the charge, the liberty of the chargor to deal with the assets is withdrawn. As between the chargor and the chargee, the chargor no longer has authority to enter into any transactions on its own account with third parties concerning the charged assets. The interest of the chargee becomes that of the holder of a fixed equitable charge over any assets that then or thereafter come within the compass of the charge. The position as between the chargee and any third party that purportedly acquires an interest in the charged assets thereafter becomes a matter of priorities between competing interests. The general priority rules (which are referred to later in this chapter) should apply, with the following modifications.

14.6.8.3.1 Where the third party had acquired an interest in a charged asset prior to crystallisation that prevailed against the charge at that time, the interest will continue to prevail notwithstanding that the charge has crystallised. Accordingly, if that interest could have been enforced by an order for specific performance, the fact that the charge has crystallised (for instance, by the appointment of a receiver) should not affect that interest.³³⁷ The position regarding an option to purchase charged assets that had been granted by the chargor to a third party prior to the crystallisation of the charge but had not been exercised prior to the crystallisation was addressed in an Irish case, in which it was held that the optionee had only a contractual right and had not acquired a proprietary right that would prevail as against the crystallised charge.³³⁸

14.6.8.3.2 Where the third party acquired an interest which would be subject to the charge if the third party had notice of the charge when it acquired its interest, it is submitted that the third party will not be defeated by knowledge of the charge if it was only aware (including due to having constructive notice, for instance, by registration of the charge) that the charge was a floating charge and did not know that it had crystallised. This would be because the knowledge it possessed was that the chargor had authority to deal with the assets and that entitled it to assume that it could safely deal with the chargor. This would be relevant, for instance, in the application of the rule in *Dearle v Hall*,³³⁹ under which a claim by a subsequent purchaser or incumbrancer may be denied the benefit of the rule, and so unable to assert priority over a prior interest, if the subsequent party had notice of the prior interest at the time that it gave value for its interest. It is submitted that the third party would not be defeated on that ground if it only knew that the charge was a floating charge and did not know that it had crystallised.

14.6.8.3.3 The position with respect to set-offs that a third party may wish to assert against the chargor (and, thus, the chargee) depends upon the nature of the set-off and whether the claim of the chargor against the third party falls within the assets subject to the charge. In this discussion, it will be assumed that the latter does fall within the charged assets. The position is as follows. The right of the third party to plead the set-off of a liquidated cross-claim as a legal set-off will cease with respect to cross-claims that arise after the third party has received notice that the charge has

³³⁷ *Freevale Ltd v Metrostore (Holdings) Ltd* [1984] Ch 199.

³³⁸ *Re Tullow Engineering (Holdings) Ltd* [1990] 1 IR 452.

³³⁹ *Dearle v Hall, Loveridge v Cooper* (1828) 3 Russ 1.

crystallised.³⁴⁰ Rights of equitable or transaction set-off that arise in consequence of a transaction that existed between the chargor and the third party prior to crystallisation of the charge will continue to be available to the parties.³⁴¹

14.6.8.4 Statutory priorities

There are a number of statutory provisions which confer priority on various persons with respect to floating charge assets and their proceeds of realisation, ahead of the interests of the chargee (irrespective of whether the charge has crystallised³⁴²), as indicated above³⁴³. In summary, they are as follows:

- (1) in a liquidation or administration of the chargor, the expenses of the winding up will enjoy priority, in so far as the assets available to the general body of creditors are insufficient to meet such expenses;³⁴⁴
- (2) preferential creditors of the chargor have a claim on such assets either ahead of the rights of the chargee or to the extent that the assets available to general creditors are insufficient to meet the claims of the preferential creditors;³⁴⁵ and
- (3) a prescribed part of such assets have to be set aside to meet the claims of unsecured creditors of the chargor.³⁴⁶

These provisions only affect the entitlement of the floating charge holder. Subject to what is said next concerning the decision in *Re Portbase Clothing Ltd*,³⁴⁷ they do not affect the right of a holder of fixed security in the charged assets.³⁴⁸

14.6.8.4.1 The position becomes more complicated where either a fixed security is expressed to rank behind a floating charge or if there is a priority agreement

³⁴⁰ *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 1 WLR 578.

³⁴¹ *Ibid.*

³⁴² This is because the provisions refer to ‘a charge which, as created, was a floating charge’. See, for instance, the definition of ‘floating charge’ in s 251 of the Insolvency Act 1986.

³⁴³ See above 14.1.4 and table 14.1.

³⁴⁴ S 176ZA of the Insolvency Act 1986, which came into force on 6 April 2008. As to the expenses that qualify for such priority, see rules 4.218 and 4.218A–4.218E of the Insolvency Rules 1986. In relation to administration, see para 99 Sched B1 Insolvency Act 1986.

³⁴⁵ See s 754 of the Companies Act 2006 (formerly s 196 of the Companies Act 1985) and ss 40 and 175(2)(b) of the Insolvency Act 1986. Section 175 is applied when an administrator makes a distribution by para 65(2) Sched B1 Insolvency Act 1986. The list of preferential debts is set out in Sched 6 to the Insolvency Act 1986

³⁴⁶ See s 176A of the Insolvency Act 1986 (applied when an administrator makes a distribution by para 65(2) Sched B1 Insolvency Act 1986. The Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097) sets out the way in which the prescribed part is to be calculated. While an application can be made to court to disapply this section, it can only be granted exceptionally. For instance, a very small return to the unsecured creditors (such as 1.5 pence in a pound) was held not be such an exception, see *Re Airbase Services (UK) Ltd* [2008] EWHC 124 (Ch), [2008] 1 WLR 1516 and *Re International Sections Ltd (In Liquidation)*, *Re* [2009] EWHC 137 (Ch), [2009] BCC 574. The High Court has held that s 176A applies only for the benefit of creditors who hold no security at all, so that a secured creditor cannot participate as an unsecured creditor with respect to that part of its claim that is not effectively covered by its security (i.e. not even for its shortfall): see *Re Permacell Finesse Ltd* [2007] EWHC 3233 (Ch), [2008] BCC 208 and *Re Airbase Services (UK) Ltd* [2008] EWHC 124 (Ch). However, it is open to a secured creditor to elect to surrender its security and thereby adopt the status of an unsecured creditor (even after the commencement of liquidation or administration) and so become an “unsecured creditor” within the scope of s 176A, see: *Kelly v Inflexion Fund 2* [2010] EWHC 2850, [2011] BCC 93; *Re J T Frith Ltd* [2012] EWHC 196 (Ch), [2012] BCC 634 This is based on rule 4.88(2) of the Insolvency Rules 1986 under which a secured creditor can voluntarily surrender his security for the benefit of the general creditors.

³⁴⁷ [1993] Ch 388.

³⁴⁸ *Re Lewis Merthyr Consolidated Collieries Ltd, Lloyds Bank Ltd v The Company* [1929] 1 Ch 498.

between the holder of the fixed security and the holder of the floating charge to that effect. Chadwick J in *Re Portbase Clothing Ltd*³⁴⁹ held that, in either case, this would affect the rights of the two securities in a proprietary sense, so that the statutory priority of the preferential creditors over the floating charge would also prevail over the security held under the fixed charge. This was because the fixed charge was subordinate to the floating charge which was itself subordinate to the claims of the preferential creditors.³⁵⁰ The same consequence should follow with respect to the priority entitlements that are statutorily conferred by sections 176ZA and 176A of the Insolvency Act 1986. The conclusion in *Re Portbase* has been heavily criticized,³⁵¹ on the grounds that the preferential creditors are unfairly elevated about the fixed charge because of the priority agreement. The subrogation solution adopted without argument in *Re Woodroffe's (Musical Instruments) Ltd*³⁵² is preferable.

14.6.8.4.2 Chadwick J did suggest that it might be possible to avoid this consequence if the agreement did not purport to govern the priorities of the two securities but, instead, provided that the fixed chargee would hold any recoveries it received on enforcement of its security on trust for the benefit of the other chargee. There is a risk, however, that the agreement to hold its recoveries on trust might imply an agreement by the fixed chargee as to the underlying security. It is suggested that a safer course would be that the fixed chargee, rather than agreeing to hold its recoveries on trust, should simply agree to pay to the other chargee an amount equivalent to whatever it received under its security. Of course, the other chargee would be taking a risk that the fixed chargee might default in the observance of its obligation, particularly should it have become insolvent in the meantime. It should be noted that the situation discussed in the this and the last paragraph is rarely likely to occur in practice, since if it is possible to take a fixed charge over an asset a secured creditor will usually do so, so that there is unlikely to be a priority battle or agreement between the holder of a fixed and a floating charge.

14.7 Taking Security Over Shares and Other Financial Securities

14.7.1 The types of financial securities over which security may be taken are numerous and may encompass shares in public companies, including listed and unlisted companies, shares in private companies, bonds and other debt instruments, government securities, and units in collective investment funds and other types of funds. Sometimes such securities may be held directly by the person that is to give the security and sometimes they may be held on its behalf by an intermediary, in which case it is likely that the entitlement will be held as part of a pool of like securities or entitlements that is held by the intermediary for a number of people. There may or may not be a physical instrument representing the relevant securities. Where there is no instrument at all, the securities are said to be 'dematerialised', in the sense that the entitlements in the securities are represented by entries recorded in electronic

³⁴⁹ [1993] Ch 388. In reaching his conclusion, Chadwick J followed and applied the decision of Nicholson J in the Victorian (Australia) case of *Waters v Widdows* [1984] VR 503.

³⁵⁰ Morritt J in *Griffiths v Yorkshire Bank PLC* [1994] 1 WLR 1427 disagreed with the approach taken in the *Portbase* case, and said that an agreement as to priorities would not have the proprietary effect contemplated by Chadwick J in the *Portbase* case.

³⁵¹ L Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 2013 5th edn) paras 5-61 to 5-62.

³⁵² [1986] Ch 366, 368, 375

registers. Even if there is an instrument, it may be a global instrument, in which case it will be isolated and removed from circulation so that dealings in it and the recording of entitlements in it may take place again through electronic means, in which case it is said that the instrument is 'immobilised'. Security interests over certain financial securities, taken in a particular way and based on an agreement between two non-natural persons may fall within the Financial Collateral Arrangements (No 2) Regulations 2003³⁵³, resulting in a different treatment, which is discussed towards the end of the section.

14.7.1.1 If security is to be taken, particularly over shares in a company, it is necessary to check that there are no provisions in the memorandum and articles of association of the issuer (or its other constitutive documents) or in any other relevant agreement (such as a shareholders' agreement) which would restrict the right of the security giver to create the security or which might restrict the enforcement of the security. Care needs to be taken to check both of those points because a permission to create security over securities may not necessarily imply a right for the securities to be sold upon enforcement of the security. It is also possible that a condition might be imposed as part of any relevant permission, which might have the effect that a purchaser of the securities would be required to accept restrictions concerning the securities, including as to its right to transfer them.

14.7.1.2 There may also be competition law aspects that should be considered, both in terms of taking the security and in the disposal of the shares upon exercise of the security. If the company operates in the regulated sector, there could also be regulatory matters that would be relevant.

14.7.1.3 There is a further point which concerns listed securities. The City Code on Takeovers and Mergers contains requirements as to building stakes or interests in the share capital of listed companies. Under Rule 9 of the Code, if a person acquires 30 per cent or more of the voting capital, or in any class of its share capital, it is required to make a mandatory bid for the company, unless a waiver has been granted by the UK Panel on Takeovers and Mergers. This requirement might be relevant both in terms of taking security and with respect to its enforcement.

14.7.2 Equitable interests in shares

Section 126 of the Companies Act 2006 provides that:

No notice of any trust, expressed, implied or constructive, shall be entered on the register of members of a company registered in England and Wales or Northern Ireland, or be receivable by the registrar.

This is often extended by the articles of association to any other type of equitable interest that might arise in the company's shares. The statutory provision, and probably its extension via the articles, has obvious consequences in terms of priorities, because it means that it is not possible to protect beneficial interests by serving notice of them on the company or its registrar. In terms of priorities, the safest course is for the security holder to perfect a legal mortgage and be registered as the holder of the shares.³⁵⁴ Where shares are uncertificated, this will involve registration in the

³⁵³ SI 2003/3226 (as amended).

³⁵⁴ See *Société Générale de Paris v Walker* (1885) 11 App Cas 20. Where there has been underhand dealings, it might be possible to obtain a 'stop notice' issued by the court and then served on the company, the effect of which is to prevent the company from registering a transfer for a limited period

CREST register.³⁵⁵ If they are held through an intermediary, a legal mortgage is not possible.³⁵⁶

14.7.3 Certificated securities and physical instruments

If the financial security is directly held by the obligor that is to give security over its entitlement and that entitlement is represented by a certificated security or physical instrument, then it will be necessary to determine if title passes by physical delivery of the certificate or instrument or if title passes by entries made in a register.

14.7.3.1 If the instrument is in bearer form, then it is likely that the instrument is negotiable and, accordingly, that title will pass by delivery of the instrument. Similarly, if title in the instrument passes by endorsement together with delivery then it is likely to be a negotiable instrument.³⁵⁷ Such a document is sometimes called a documentary intangible. Title is represented by the instrument, including title in the payment and other rights encapsulated by the instrument. Examples of such instruments include bills of lading, bills of exchange, promissory notes, certificates of deposit, bearer bonds and bearer shares (share warrants). It should be noted that as of 26 May 2015³⁵⁸ UK companies may no longer issue bearer shares and there are provisions for cancellation and conversion of them into registered shares.³⁵⁹ Security in bearer instruments may be taken in a possessory form, by pledge or lien, where the creditor obtains possession of the instrument (endorsed in blank, if necessary). Alternatively, security may be taken in a non-possessory form, but that is much more risky, as the obligor has been left armed with the instrument and can confer a superior title on an innocent third party who obtains the instrument without notice. A middle ground, which has no particular advantage over the use of possessory security, is to take security by way of mortgage or charge but also to take possession of the instrument.

14.7.3.2 If the transfer of the entitlement represented by the instrument requires registration in a register that is kept by or on behalf of the issuer, the instrument would not be negotiable. A typical example would be the shares in an English private company. In such a case, it is not possible to have an effective pledge or lien over the instrument and the entitlements that it represents.³⁶⁰ Worthwhile security can only be taken in the form of a mortgage or charge. A legal mortgage requires that the mortgagee is registered as the holder of the relevant entitlement. An equitable mortgage requires an agreement that the entitlement should be transferred, together with the means to obtain the transfer, such as an executed form of share transfer and the relevant share certificate. Technically, a charge does not require the executed share transfer, but it is sensible to obtain it for ease of enforcing the security, should that be necessary.

pending an application to the court for an injunction, but this is of limited effect: *Re Holmes* (1885) 29 ChD 786.

³⁵⁵ See 14.7.4.

³⁵⁶ See 14.7.5 below.

³⁵⁷ As to negotiable instruments, see the discussion in Chap 10.

³⁵⁸ The date of entry into force of the Small Business, Enterprise and Employment Act 2015, section 84, which added section 779(4) of the Companies Act 2006. See also sections 85-86 of the Small Business, Enterprise and Employment Act 2015.

³⁵⁹ Schedule 4 of the Small Business, Enterprise and Employment Act 2015.

³⁶⁰ The effect of attempting to obtain such security is merely to create a pledge or lien over the piece of paper, but not the rights to which it refers, see *Colonial Bank v Cady & Williams* (1890) 15 App Cas 267 (HL)

14.7.4 Uncertificated securities

Such securities are most likely to be issued by listed³⁶¹ or other large companies, sovereign or governmental issuers, supra-national bodies, and similar institutions. In the UK, uncertificated (or dematerialized) securities are held through the CREST system, which is run by Euroclear (UK and Ireland) Ltd (EUI).

14.7.4.1 *The CREST system*

The Uncertificated Securities Regulations 2001³⁶² provide the legislative basis for the establishment and operation of the CREST system, under which rules and conditions have been formulated for the operation of the system. The operator of the system is EUI. In summary of a rather complex system, the operator maintains a computerised system in which are recorded entitlements in dematerialised securities issued by eligible issuers, which are mostly UK incorporated issuers, but also include some foreign issuers (the discussion will assume that the securities have been issued by a UK issuer). The system maintains accounts to record entitlements of its participating members in the relevant securities. Such members may be direct users, who have direct computerised access to the system, or sponsored members who connect to the system via a direct user.³⁶³ Whichever type of member it may be, the system will record entitlements credited to its account. Members may hold a recorded entitlement for themselves or on behalf of one or more third parties, in which case the member would be acting as an intermediary on behalf of the third parties.

14.7.4.1.1 A member's account in the system will distinguish between each issue of securities that are held in the member's account. For each such issue, the account will also distinguish between securities that the member holds for itself and those that it holds for other persons, where it is acting as an intermediary. It is also possible for the account to designate securities that are held under escrow, where a transaction cannot take place without the authority of the designated 'escrow agent', being another member of the system.

14.7.4.1.2 The eligible securities of an issuer may be held in dematerialised form through the CREST system or in certificated form outside the system. The recorded holder of a security has the right to require that a security be removed from the system and re-issued in certificated form, or that the opposite should occur, by surrendering the certificated form of the security (together with a form of transfer) so that it is credited in dematerialised form to a member's account in the system. Whichever form is used, the relationship between the issuer (if it is a UK issuer) and the registered holder remains the same and, in that sense, the CREST system does not act as an intermediary.³⁶⁴ It is simply acting as a system for recording the legal position as between the issuer and the account holder. Legal ownership of the securities rests in whoever is recorded as owner, either through the system or in physical records kept by the issuer or its registrar.³⁶⁵ Where a security is held through the system, a back-up

³⁶¹ All shares traded on the London Stock Exchange must be eligible for electronic trading ie must be potentially available in uncertificated (ie dematerialised) form: FCA Handbook, LR 6.1.23-6.1.24

³⁶² SI 2001/3755 (as amended). The regulations were made under s 207 of the Companies Act 1989 and continue pursuant to ss 783–788 of the Companies Act 2006.

³⁶³ Even individuals can be sponsored members.

³⁶⁴ The position is different for securities issued by non-UK issuers.

³⁶⁵ Though note that the CREST register is only prima facie evidence of title, and can be rectified, see Uncertificated Securities Regulations 2001, reg 24(6) in relation to shares and 24(8) in relation to eligible debt securities,

record will be kept by the issuer or its registrar (which will be notified by the system of any transfers), but it is the entitlement as recorded in the system which is decisive of legal ownership.³⁶⁶

14.7.4.1.3 A legal mortgage of uncertificated securities in the CREST system can be accomplished by a transfer to the account of the mortgagee, if it has an account in the system. Any other form of transfer within the system will only achieve a form of equitable security and no notice of any trust can be entered on the system. Where the security giver is a member of the system, it can transfer the charged securities to its escrow account, by way of charge. Alternatively, where the chargor is not a member of the system, it could instruct its intermediary to transfer the securities to the intermediary's escrow account. The consequence of this is that the securities cannot be transferred from the escrow account without an instruction from the designated escrow agent, which would be the chargee (if it is a member of the system) or (if the chargee is not a member of the system) a member acting as its agent.

14.7.4.1.4 The alternative procedure to taking security over uncertificated securities in the CREST system, particularly shares, is for the securities to be taken out of the system so that they are converted into certificated securities and then made subject to the more traditional methods for establishing security as described earlier.

14.7.5 Intermediated securities

It is extremely common for securities (either equity or debt) to be held through an intermediary. This may be because the securities are issued in the form of a global instrument, which is immobilized and held by a depository for an International Central Securities Depository (ICSD): in Europe the ICSDs are Euroclear (which is in Belgium) and Clearstream (which is in Luxembourg).³⁶⁷ The ICSDs act as intermediaries for their own account holders, who are banks, and whom may hold for their own account or for the account of others. Securities may also be held through an intermediary when the root of legal title is the CREST register or (though this is unlikely in practice) where the top tier intermediary holds certificated or bearer securities. Intermediation brings a number of benefits, which vary somewhat depending on the characteristics of the ultimate holder.³⁶⁸ For those individuals and institutions who hold securities for the long term, in order to benefit from capital growth as well as income, intermediation provides management and administration services provided by the intermediary, as well as the custodial security and ease of transfer, if and when desired. For those institutions, such as hedge funds, who acquire and hold securities in order to trade them, and to make profits through arbitrage, the advantages of intermediation are the speed and ease of transfer through the use of pooled accounts, as well as the finance provided by the intermediaries (such as prime brokers) for the acquisition of the securities (secured on the securities themselves).³⁶⁹

³⁶⁶ Uncertificated Securities Regulations 2001 reg 24(2).

³⁶⁷ Most global immobilised securities are bearer securities, but it is also possible to have a registered global security held through Euroclear or Clearstream. The US system of holding (usually through the ICSD Deposit Trust Company) is based on registered global immobilised securities.

³⁶⁸ For an analysis of the different types of ultimate holder, and the differences that this should make to the regulation of this area of law, see J Benjamin, 'The law and regulation of custody securities: cutting the Gordian knot' (2014) 9 *Capital Markets Law Journal* 327.

³⁶⁹ See L Gullifer and J Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, Hart Publishing 2015), 4.6.4.

14.7.5.1 The legal analysis of intermediated securities

Where securities are held through an intermediary, there are typically at least three tiers of holding, often a great deal more. The top tier is, under English law, the legal owner of the securities. Where securities are represented by a global security, this will be the depository who is the holder of a global bearer security, or the registered owner of a global registered security. If securities are registered in CREST, the person in whose name they are registered is the legal owner. In all cases, under an English law analysis,³⁷⁰ the legal owner holds the securities on trust for the next person down the chain (the first tier intermediary). In Europe, in the case of a global security, this person will be Euroclear and/or Clearstream.³⁷¹ The first tier intermediary therefore has a beneficial proprietary interest in the securities. It is unlikely, however, to be the ultimate beneficiary. Instead, it will hold its interest under the trust on a sub-trust for its account holders, who may themselves hold their interest under the sub-trust on a sub-sub-trust for their own account holders, and so on down the chain.³⁷² The details of each holding are recorded in accounts maintained by each participant in the chain. The person at the bottom of the chain, the investor, has the main economic interest in the securities, but will not have any relationship with the issuer; instead, its relationship is only with its own intermediary. Indeed, this is the case in relation to each person in the chain. The ‘no look-through’ principle means that only the legal owner can sue the issuer for payment, and that each person in the chain can only sue those directly above or below them in the chain in relation to the contract and trust relationships between them.³⁷³ In fact, they are usually unaware of the identity of other participants in the chain. Thus, what any person in the chain owns (apart from the legal owner at the top of the chain) is an equitable interest in whatever interest (legal or equitable) the intermediary above them in the chain owns. There have been various names for this asset: ‘interest in securities’,³⁷⁴ ‘security entitlement’³⁷⁵ and ‘book entry securities’³⁷⁶. Here, the first will be used, that is, ‘interest in securities.’

14.7.5.2. Interests in securities are transferred by book entry in the books of the lowest tier intermediary common to both transferor and transferee. If both transferor and transferee hold with the same intermediary, and the interests in securities are held in a pooled account, the entries are made merely in the books of that intermediary. If, on the other hand, the transferor and transferee have accounts with different intermediaries, entries will need to be made in the books of both intermediaries, plus *their* intermediaries and so on up the chain until a common intermediary is reached.

³⁷⁰ English law may well not apply to this relationship: Euroclear is based in Belgium and Clearstream in Luxembourg and national law is likely to determine the precise legal nature of the relationship.

³⁷¹ There is a ‘bridge’ arrangement by which most global securities are held for both Euroclear and Clearstream as first tier intermediaries.

³⁷² See *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 (Ch), [226]; *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch), - [2014] 2 BCLC 295, [163].

³⁷³ See *Secure Capital SA v Credit Suisse AG* [2015] EWHC 388 (Comm), [2015] 1 Lloyd's Rep 556 [10], [15] and [58]

³⁷⁴ J Benjamin, *Interests in Securities* (Oxford University Press 2000)

³⁷⁵ US Uniform Commercial Code (Article 8)

³⁷⁶ Financial Collateral Directive 2002 (Directive 2002/47/EC) and other EU legislation.

The legal analysis of such transfers is not entirely clear, but the preferable analysis is that it takes place by novation.³⁷⁷

14.7.5.1.2. As mentioned above, intermediaries often hold interests in securities in a ‘pooled’ or ‘omnibus’ account. This means that the intermediary’s own account, with the person above them in the chain, records the entire nominal amount of securities of a particular issue that it holds for clients.³⁷⁸ The books of the intermediary record the separate nominal amounts of those securities held for each of its clients. This has two advantages. The first is ease of transfer, as described above. The second is that the intermediary can use the whole pool of securities to generate income for itself and its clients, either through securities lending transactions, or as collateral, via repos or security financial collateral arrangements.³⁷⁹ While there was initially some disquiet that securities held in a pooled account³⁸⁰ could not form the subject matter of a valid trust, it is now clear that both the nature of an issue of securities itself and the manner of holding means that investors actually have a co-ownership interests which can be the subject matter of a valid trust.³⁸¹

14.7.5.3. Since the interest of any account holder in the system of intermediated securities is necessarily an equitable interest (only the depositary or registered owner has a legal interest), security over such an interest can be granted only by equitable mortgage or by fixed or floating charge.³⁸² The former can be created by the transfer of the interest into the name of the mortgagee in the books of an intermediary, or by an assignment of the mortgagor’s account to the mortgagee. The latter method suffers from the disadvantage that the assignee takes subject to equities. A charge can be created by agreement, although if it is to be a fixed charge, the charge will have to provide that the chargor cannot deal with its interest without the consent of the chargee, and the chargee will probably have to give notice of this to the intermediary.³⁸³ The degree of possession or control necessary for a security interest to be a security financial collateral arrangement is discussed in the next section.

14.7.5 The Financial Collateral Arrangements (No 2) Regulations 2003³⁸⁴

These Regulations purport to implement in the UK the EC Directive on financial collateral arrangements.³⁸⁵ The Regulations have the effect of modifying certain

³⁷⁷ See L Gullifer and J Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, Hart Publishing 2015) 2.6.2.

³⁷⁸ The intermediary may well have a separate account recording the securities it holds for itself.

³⁷⁹ See 14.7.6.

³⁸⁰ This is a shorthand term for what is actually interests in a sub-trust held in a pooled account.

³⁸¹ See L Gullifer (ed) *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 5th ed 2013) paras 6.14 to 6.19, and *In The Matter Of Lehman Brothers International (Europe) (In Administration)* [2009] EWHC 2545 (Ch) [56]; *Lehman Brothers International (Europe) (in admin) [2010] EWCA Civ 917* [171]; *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 2914 (Ch) [232] and [2011] EWCA Civ 1544 [69] et seque.

³⁸² Note that where securities are issued as a global security, there is usually provision for definitive certificated securities to be issued in certain circumstances. Often this is limited to events of default, but sometime the beneficial owners have a right to call for such definitive securities, in which case a legal mortgage could be then granted. However, issuing definitive securities is an expensive and lengthy process.

³⁸³ See section 14.6.6.2.2.

³⁸⁴ SI 2003/3226.

³⁸⁵ Directive on Financial Collateral Arrangements 2002/47/EC of the European Parliament and Council of 6 June 2002, OJ L 168/43 (as amended).

formalities and requirements of the law in the UK with respect to such an arrangement, extending the rights of a recipient under such an arrangement by way of security to the use and appropriation of financial collateral, and providing a conflict of laws rule where financial collateral is held through an intermediary. The latter aspect is discussed in Chapter 10.

14.7.5.1 Scope of application

An arrangement will not be treated in a manner provided for in the Regulations unless it falls within their scope. The Regulations apply to certain arrangements, evidenced in writing³⁸⁶, involving financial collateral entered into by non-natural persons. Each of these elements is defined in the Regulations and is outlined below.

14.7.5.1.1 The Regulations apply where each of the parties to a financial collateral arrangement is a ‘non-natural person’ (i.e. not an individual). In this respect, the Regulations go further than merely implementing the Directive, because the Directive requires that at least one of the parties should be a specially designated type of entity.³⁸⁷ Motivated by this and because the Regulations were made pursuant to power conferred on HM Treasury under s 2(2) of the European Communities Act 1972, it was questionable if they were validly made, at least in so far as they seemed to go further than the Directive required or permitted. This issue was raised in *R (on the application of Çukurova Finance International Ltd) v HM Treasury*³⁸⁸ but it was not fully considered because the court held the claimants were not entitled to an extension of time within which to challenge the Regulations. A limited assessment of the issue was made in light of the question whether the merits of the claimant’s case were so strong so as to justify hearing the matter notwithstanding what would otherwise constitute undue delay. In that context, the wider scope of the Regulations was considered sufficiently closely connected to the purpose of the Directive, which were protection of major entities in the financial markets and protection against systematic risk. It remains questionable, however, whether this rationale is engaged in every case, for example where the Regulations apply to business financing arrangements³⁸⁹ rather than financial market agreements.

14.7.5.1.2 Financial collateral takes one of three forms: ‘cash’, ‘financial instruments’ and (since 6 April 2011³⁹⁰) ‘credit claims’. ‘Cash’ is basically the credit balance, in any currency, on an account or a similar claim for repayment, including money market deposits and sums due or received in relation to certain financial markets operations. ‘Financial instruments’ is widely defined to include shares in

³⁸⁶ See the definitions of “security financial collateral arrangement” and “title transfer financial collateral arrangement” in regulation 3(1) of the Financial Collateral Arrangements (No 2) Regulations 2003.

³⁸⁷ These are basically (a) a public authority; (b) a central bank, the European Central Bank, multilateral development bank, the IMF, BIS, or EIB; (c) a financial institution subject to financial supervision; or (d) a central counterparty, settlement agent or clearing house): see Art 1(2) of the Financial Collateral Directive.

³⁸⁸ [2008] EWHC 2567 (Admin).

³⁸⁹ Such as those found in *Gray v G-T-P Group Ltd; Re F2G Realisations Ltd (In Liquidation)* [2010] EWHC 1772 (Ch), [2011] BCC 869. See further L Gullifer, ‘What Should We Do About Financial Collateral?’ (2012) 65 CLP 377.

³⁹⁰ The date of entry into force of the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010/2993 implementing Directive 2009/44 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims.

companies,³⁹¹ bonds and similar debt instruments tradeable on the capital market, and other types of securities and financial instruments and claims and rights derived therefrom. ‘Credit claims’ are essentially claims for repayment of loans made by credit institutions.³⁹²

14.7.5.1.3 Financial collateral arrangements take the form of either a title transfer financial collateral arrangement or a security financial collateral arrangement. The former involves an outright transfer of title to the collateral taker with an obligation to re-transfer equivalent collateral at a later time for the purpose of securing a financial obligation.³⁹³ It includes a repurchase agreement (or ‘repo’) A ‘security financial collateral arrangement’ is an agreement or arrangement under which the collateral provider creates a security³⁹⁴ over financial collateral and a requirement is fulfilled, which is that the collateral must be placed in the possession or under the control of the collateral taker. The Regulations provide that possession or control is not defeated if the collateral provider has rights to substitute or withdraw excess collateral. While the Regulations provide that security can take the form of a pledge, lien, mortgage (whether legal or equitable), fixed charge or a floating charge, what is critical is the requirement that the collateral taker takes “possession or control” and whatever security is taken it has to comply with this requirement if it is to fall within the Regulations.

14.7.5.1.4 The meaning of “possession or control” has been subject to extensive debate, two first instance decisions³⁹⁵ and a 2010 amendment to the Regulations. The amendment defined in regulation 3(2) the term “possession” in relation to cash collateral and financial instruments³⁹⁶ as including a situation where collateral is credited to an account in the name of the collateral taker provided that any rights of the collateral provider are limited to the right to substitute financial collateral of the same or greater value or withdraw excess collateral. The term “control” has been interpreted by the courts to mean legal control (ability to permit or prohibit acts based on parties’ security agreements), not factual control (actual ability of the collateral taker to dispose of the collateral or to prevent the collateral provider from disposing of

³⁹¹ Once again, the Regulations depart from the text of the Directive. The Regulations encompass all types of shares in companies, including private and unlisted companies. However, it appears from the definition of ‘financial instruments’ in Art 2(1) of the Directive that shares in a company should be tradeable on the capital market, which would exclude shares in a private or unlisted company.

³⁹² Defined as an undertaking whose business is to take deposits or from the public and to grant credits for its own account: see Article 4(1)(1) of Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms and including institutions listed in Article 2(5)(2) to (23) of Directive 2013/36/EU. The key types of institution falling within the definition are banks, central banks and post office giro institutions.

³⁹³ While the Financial Collateral Arrangement (No 2) Regulations 2003 refers to “financial obligations owed to the collateral taker” these words should be interpreted in light of the Directive’s less restrictive formulation of “relevant financial obligations”, which suggests that at the very least the Regulations cover financial obligations owed to trust beneficiaries where the collateral taker is a security trustee, see R Parsons and M Denning, ‘Financial Collateral – an Opportunity Missed’ (2011) FMLR 164, 174.

³⁹⁴ Under the Financial Collateral Arrangement (No 2) Regulations 2003 the arrangement or agreement must be for the purposes of security of a financial obligation owed to a collateral taker but the Directive is less prescriptive in this respect since there is no mention of a secured obligation, which could open the Regulations to an interpretation that a security arrangement could exist even if the obligation did not (it would not be possible to enforce it but it might matter for other reasons).

³⁹⁵ *Gray v G-T-P Group Ltd; Re F2G Realisations Ltd (In Liquidation)* [2010] EWHC 1772 (Ch), [2011] BCC 869 and *Re Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch), [2014] 2 BCLC 295.

³⁹⁶ Regulation 3(2) of the Financial Collateral Arrangements (No 2) Regulations 2003.

the collateral). However, an argument could be made that factual control should be more important because it provides some outward indication to other parties whereas contractual agreement does not.³⁹⁷ Courts further found that control must be negative that is, the chargor is not able to deal with the collateral without the consent of the chargee. Positive control, in the sense of the ability of the collateral taker to dispose of the collateral without a further involvement of the collateral provider, is neither sufficient nor necessary. While it is clear that the collateral provider's rights to dispose of the collateral (other than when coupled with substitution) are inconsistent with the collateral taker's control or possession, it would be unfortunate if the collateral provider's other rights, such as rights to dividend or income, voting rights or rights to require a third party custodian to transfer collateral if collateral taker is insolvent would also be so inconsistent although the literal interpretation of regulation 3(2) of the Financial Collateral Arrangements (No 2) Regulations would so suggest.³⁹⁸

14.7.5.2 Modifications to formal and registration requirements under English law

The Regulations make the following modifications to the requirements of English law relating to formalities and registration, in so far as financial collateral arrangements are concerned:

- (1) With respect to guarantees, the requirement as to writing and the necessity for a signature under section 4 of the Statute of Frauds 1677 shall not apply (Regulation 4(1)) although it is difficult to see that this formality would generally apply to a financial collateral arrangement.
- (2) With respect to dealings in equitable interests, the requirement as to writing and the necessity for a signature under section 53(1)(c) of the Law of Property Act 1925 shall not apply (Regulation 4(2)).
- (3) With respect to an absolute assignment of a chose in action, the requirement that the assignment should be signed by the assignor or his agent under section 136 of the Law of Property Act 1925 shall not apply (Regulation 4(3)).
- (4) Sections 859A and 859H of the Companies Act 2006 (the obligation on the registrar to register company charges and the consequences of its lack of registration shall not apply (Regulation 4(4)). This has the effect that security financial collateral arrangements fall within section 859A(6)(c) as 'a charge excluded from the application of this section by ... any other Act'.³⁹⁹
- (5) The obligation to file information relating to charges under section 4 of the Industrial and Provident Societies Act 1967 shall not apply.

14.7.5.3 Modifications to English insolvency law

Enforcement of a financial collateral arrangement on insolvency is meant to be quick, easy and predictable as to its consequences. As a result, the Regulations make the following modifications to the provisions of English insolvency law under the Insolvency Act 1986 (the 'Act'), in so far as financial collateral arrangements are concerned:

³⁹⁷ L Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell, 5th ed, 2013) para 6.35.

³⁹⁸ See S Goldsworthy, 'Taking possession and control to excess: issues with financial collateral arrangements under English law' [2013] JIBFL 71.

³⁹⁹ See generally 14.13.

- (1) The restrictions on enforcement of security in an administration and to the appointment of a receiver⁴⁰⁰ do not apply, nor may the administrator deal with the charged property⁴⁰¹ (Regulations 8 (1) and (2)).
- (2) The provisions concerning the effect of a moratorium for an eligible company that is the subject of a proposal for a voluntary arrangement, as they relate to disposals of charged property and enforcement of security,⁴⁰² shall not apply (Regulation 8(5)).
- (3) Section 127 of the 1986 Act shall not apply to avoid any disposition or creation of property under such an arrangement or to prevent a close-out netting provision⁴⁰³ from taking effect (Regulation 10(1)).
- (4) Section 88 of the 1986 Act shall not apply to any transfer of shares under such an arrangement (Regulation 10(2)).
- (5) Section 40 and 175 of the 1986 Act (preferential debts) shall not apply to any debt secured by a charge under such an arrangements (Regulation 10(2A)).⁴⁰⁴
- (6) Section 176ZA of the 1986 Act (expenses of winding up) nor paragraph 99 Schedule B1 of the 1986 Act (expenses of administration) shall not apply to any claim or property arising under such an arrangements (Regulations 8(1) and 10(2B)).
- (7) Section 176A of the 1986 Act shall not apply with respect to any floating charge within a security financial collateral arrangement (Regulation 10(3)).
- (8) Section 178 of the 1986 Act shall not apply with respect to any such arrangement (Regulation 10(4)).
- (9) Section 245 of the 1986 Act shall not apply to any floating charge within a security financial collateral arrangement (Regulation 10(5)).
- (10) Section 754 of the Companies Act 2006⁴⁰⁵ shall not apply to any floating charge within a security financial collateral arrangement (Regulation 10(6)).
- (11) A close-out netting provision is to take effect notwithstanding the winding up, administration, or voluntary arrangement of a party, provided that the party asserting the provision lacked notice or awareness that the proceedings had been commenced or were pending when it entered into the financial collateral arrangement or when the relevant secured obligations arose (Regulation 12).
- (12) A party entering into a financial collateral arrangement or taking possession or control of such collateral will not be affected, as against third parties, by the making of a winding-up order against, or the appointment of an administrator of, a party to the arrangement on the day it entered into that arrangement or took possession of collateral (even if after the making of the order or appointment) if it was not aware (or should not have been aware) of the making of the order or appointment of administrator (Regulation 13).

⁴⁰⁰ Under, respectively, paras 43(2), 44, 41(2) to the 1986 Act.

⁴⁰¹ Under paras 70 and 71 of Sched B1 to the 1986 Act.

⁴⁰² Under, respectively, paras 20 and 12(1)(g) of Sched A1 to the Insolvency Act 1986.

⁴⁰³ A 'close-out netting provision' is a provision for netting or set-off that is contained in a financial collateral arrangement or an arrangement of which a financial collateral arrangement forms a part or any similar legislative provision, under which upon the occurrence of an 'enforcement event' (which is widely defined) either (a) the obligations of the parties are accelerated or terminated with a balance sum due which represents the estimated current value or replacement cost, or (b) an account is taken of the parties' obligations and a balance sum is due one way or the other, see regulation 3(1) of the Financial Collateral Arrangement (No 2) Regulations 2003.

⁴⁰⁴ This also has effect in administration as these sections expressly apply there as well by dint of para 65(2) Sched B1 Insolvency Act 1986.

⁴⁰⁵ Formerly s 196 of the Companies Act 1985.

14.7.5.4 *The right to use financial collateral*

As mentioned earlier, intermediaries often wish to make money from using interests in securities (particularly those held in omnibus accounts) in repos or securities lending transactions.⁴⁰⁶ Such activities is also commonly done by collateral takers (in fact, intermediaries are often themselves collateral takers under a security financial collateral arrangement to secure advances made to their clients to acquire interests in securities: prime brokerage). The use of securities in this way has the effect of reducing the cost of finance and of intermediation. Under title transfer financial collateral arrangements there are no difficulties in principle for the collateral taker to re-use the collateral. The collateral taker becomes the owner of the collateral, and can therefore transfer its interest freely to the repo or securities lending counterparty.

14.7.5.4.1 The position is not so in relation security. A secured party is usually not permitted to dispose of the secured assets in a way that jeopardises the equity of redemption of the security provider⁴⁰⁷ (it is possible to grant a sub-mortgage or a sub-charge, that is, to create an interest only over the security taker's interest.) However, part 4 of the Financial Collateral Arrangements (No 2) Regulations makes provision for the holder of security under a security financial collateral arrangement to use and dispose of the collateral before enforcement of the security. if the terms of the arrangement permit it to do so (and subject to those terms). This does not apply to credit claims.⁴⁰⁸

14.7.5.4.1 Under Regulation 16, the right of use and disposal prior to enforcement is exercisable by the security holder as if it were the outright owner of the collateral, but there is a (personal) obligation to replace what has been used and disposed of prior to the due date for performance of the secured obligations, by transferring back to the other party equivalent financial collateral⁴⁰⁹ to that which was used, or (if permitted by the terms of the arrangement) by setting-off the value of what has been used against the secured obligations.⁴¹⁰ Where securities are held by way of a trust, the right of use could be considered inconsistent with the trustee's duties. However, there is some support in the cases for the view that this is still a trust, albeit an unusual trust, especially given the clear intention of the parties.⁴¹¹ In one sense, the provider of the collateral is taking a risk by permitting the security holder to use and dispose of the collateral, as the obligation to restore equivalent collateral is merely a personal

⁴⁰⁶ In a repo the securities (or the interest in securities) is sold to another party and then repurchased at a later date. The purpose of the transaction is for the buyer to provide finance to the seller. The structure of a securities lending transaction is the same, but the purpose is for the purchaser to 'borrow' securities to support short selling (the transaction is not a true loan, but is similar to the Roman law *mutuum*).

⁴⁰⁷ The position is, of course, different on default. A secured party then has a right of sale which is implied by law (and is usually included in the security agreement): *Re Morritt* (1886) LR 18 QBD 222, 223; *Stubbs v Slater* [1910] 1 Ch 632, 639, and in relation to mortgage by deed exists by virtue of section 101 of the Law of Property Act 1925. See below 14.17.

⁴⁰⁸ Regulation 16(1) of the Financial Collateral Arrangement (No 2) Regulations 2003.

⁴⁰⁹ 'Equivalent financial collateral' means, for cash, the same amount in the same currency, and, for financial instruments, means (unless otherwise specified in the arrangement) instruments of the same issuer, amount, currency, class and description: regulation 3(1) of the Financial Collateral Arrangement (No 2) Regulations 2003.

⁴¹⁰ For a similar analysis that there is nothing inherently inconsistent in the parties' contractual agreement that the mortgagee can dispose of the mortgage property, see *Lift Capital Partners Pty Ltd v Merrill Lynch International* [2009] NSWSC 7, (2009) 73 NWS 404 at 136-137 (Barrett J).

⁴¹¹ See Briggs J in *Re Lehman Brothers International (Europe) (In Administration)* [2009] EWHC 2545 (Ch) at [52] and [63]-[64].

obligation of the security holder. The risk can be minimised if it is also provided that a failure by the security holder to do so will result in an automatic set-off of the value of the collateral against the secured obligations.⁴¹² The risk is not entirely removed, however, as the collateral provider will suffer to the extent that the value of the collateral exceeds the amount of the secured obligation.

14.7.5.5 *The right to appropriate financial collateral*

Under regulation 17, the terms of the arrangement provide for it, the security holder may exercise a power of appropriation of the collateral, without having to obtain an order for foreclosure from the court.⁴¹³ Appropriation, broadly speaking, is a self-help remedy whereby the collateral taker is able to take the collateral in satisfaction of the secured obligation, but owes a personal obligation to the collateral provider to account for any surplus value (calculated in accordance with the terms of the agreement, and, in any event, in a commercially reasonable manner).⁴¹⁴

A question has arisen as to what is required to constitute an ‘appropriation’ of the collateral for the purposes of regulation 17. Where the collateral taker has a legal mortgage, it will acquire full legal title on appropriation. However, where the security interest is equitable,⁴¹⁵ it will acquire full equitable (beneficial) title. This can be effected by merely giving notice to the collateral provider⁴¹⁶: there is no need to carry out the formalities required to transfer legal title.⁴¹⁷ The 2010 amendment to the Regulations provided that the security collateral taker acquires legal and beneficial title: this is plainly a drafting error and is very unfortunate. It is submitted that the provision should be understood that the appropriation can take place by acquiring either equitable or legal title.⁴¹⁸

14.8 Taking Security over Intellectual Property

14.8.1 When considering assets that might fall within the compass of security, a creditor will usually think of tangible assets (land or goods) and intangible assets in the nature of choses in action (debts or receivables), but increasingly one of the most important available assets is the obligor’s intellectual property (IP). Pure IP differs from other types of intangible rights because, whilst being intangible property, it is largely constituted by a monopoly in its use and exploitation. Although the rights in IP may be asserted against third parties, their essence is in protecting that monopoly and exploiting the rights associated therewith, rather than simply being founded upon a chose in action. The IP rights concerned relate to trade marks, patents, registered designs, copyright, unregistered design rights, and database rights.

⁴¹² Collateral providers under prime brokerage agreements are now to be made aware of the risks of the right of use. Such agreements should now have a disclosure annex laying out the risks clearly, see CASS r.9.3.1.

⁴¹³ Appropriation has not been known to English law. Sale of the asset by the mortgagee to oneself was not permitted even if at market price, see *Hodson v Deans* [1903] 2 Ch 647.

⁴¹⁴ Regulation 18.

⁴¹⁵ This could be the only type of security interest available in the circumstances, if the collateral provider’s interest is merely equitable, for example, an interest of an account holder in intermediated securities.

⁴¹⁶ ‘Taking thought’ is not enough, see *Cukurova Finance International Limited, Cukurova Holding A.S v Alfa Telecom Turkey Ltd* [2013] UKPC 19, [35].

⁴¹⁷ *Cukurova Finance International Limited, Cukurova Holding A.S v Alfa Telecom Turkey Ltd* [2013] UKPC 19, [34].

⁴¹⁸ See L Ho, ‘The Financial Collateral Directive’s Practice in England’ (2011) JIBLR 151, 172; L Gullifer (ed), *Legal Problems of Credit and Security* (Sweet & Maxwell 5th edn 2013) 6.50.

14.8.1.1 At the same time, it may also be relevant to think of other rights and assets (which could be tangible or intangible) which are associated with or similar to IP rights or which may have been derived by the application or exploitation of IP rights. Accordingly, it may be advisable to deal with physical assets which represent the physical embodiment or use of the relevant right and rights derived from the exploitation or use of IP rights. An important point to note from this is that in attempting to deal with one aspect, it may be necessary to deal separately with a related aspect and not to confuse the two. By way of two examples, a contrast can be made between the bare IP right and a licence that is granted or received to use that right. A contrast may also be made between the IP right and a physical asset made from using it or to which the IP right is applied.

14.8.1.2 A distinction which also needs to be made is between pure IP rights and rights that have similar characteristics but which may not be susceptible to the usual forms of dealing with property rights. This will be relevant to rights associated with confidential information, business reputation (including a right to sue for passing off), and know-how. There is a right to protect them, such as by preserving them from disclosure or from wrongful interference, but it is not a transferable right. It may not be possible to take security over such rights except in the sense of including them within a general charge over the undertaking and goodwill of the business of the chargor or by taking security over the benefit of claims for damages where such rights have been infringed.

14.8.1.3 Some businesses are almost entirely dependent upon their IP, such as those which rely upon brand names, copyright, or patents. The value of IP lies in the ability of the holder to exploit its monopoly right (either by its own use or by licensing others to do so), although the accounting profession has wrestled with how such value should be defined and recorded (if at all) for accounting purposes. The valuation of IP and associated rights suffers from challenges not typically present in relation to other assets and methods of IP valuation are being examined and developed.⁴¹⁹ Further, even if a business considers itself to be the owner of the IP, it may lose its monopoly right as, for instance, by a failure to exploit the right, by a failure to keep its registration of the right up to date, by expiry of a statutory right, or due to a challenge to the essential validity of the right.⁴²⁰ There may also be an issue as to the true ownership of the IP rights. For instance, if the rights were created under contract by a contractor rather than by an employee acting within the course of his employment, the rights may have vested in the contractor rather than the person who engaged the contractor.⁴²¹ In such a case, it will be necessary to ensure that the contract provides adequately with respect to the rights. When drafting an instrument creating security over IP rights the creditor may wish to include express warranties, for example relating to non-infringement or freedom from licences, as well as to seek to rely on the various implied covenants and guarantees of title under Law of Property

⁴¹⁹ See generally Intellectual Property Office, ‘[The role of intellectual property and intangible assets in facilitating business finance. Final report](#)’ (2013/34), available at www.ipo.gov.uk (last accessed September 2015). In addition, the research and evaluation priorities for 2015/16 published by the Intellectual Property Office on 9th September 2015 include value of IP, available at <https://www.gov.uk>. Separately from this, various tools are being developed to help business value their IP, see: www.inngot.com.

⁴²⁰ For instance, that a patent may be challenged on the basis that, when granted, it was not novel or that it did not involve an inventive step.

⁴²¹ See, for instance, s 11(2) of the Copyright, Designs and Patents Act 1988 and contrast that with Regs 14 and 15 of the Copyright and Rights in Databases Regs 1997 (SI 1997/3032).

(Miscellaneous Provisions) Act 1994.⁴²² Notwithstanding the various protection mechanisms, the IP rights may be open to challenge, so the creditor should also take into account the likelihood of this happening and may wish to consider taking insurance or obtain waivers where possible⁴²³. These issues as to ownership and value and as to the strength of IP and associated rights will also be relevant to a creditor in assessing the strength of the borrower's business and the reliance to be placed upon its IP and associated rights as security.

14.8.1.4 From a different perspective, it may also be necessary for a creditor to consider the strength of its borrower when the borrower is dependent upon the ability to use an IP right which is licensed to it by a third party. If the licence is taken away then the borrower's business may collapse. In addition, the licence will have to be examined to determine if it permits the borrower to grant security over its rights under the licence and, if it does, if there are any restrictions upon transferring the benefit of the licence if the security is enforced. In similar vein, it will be necessary to determine if the licence might be revoked upon a change in ownership or control of the borrower.

14.8.1.5 In seeking to take security over IP rights, the creditor will consider the usual forms of security (i.e. legal mortgage, equitable mortgage, fixed charge, and floating charge) but some situations will call for one type of security rather than another. While unregistered IP rights tend to be covered by a floating charge⁴²⁴, registered IP rights are generally subject to fixed security, even by way of legal mortgage,⁴²⁵ but the difficulties in doing this, in terms of vesting control in the creditor (as discussed earlier in this chapter), must be borne in mind. A legal mortgage would involve a full assignment to the creditor of all of the relevant rights, subject to a right of redemption. From the perspective of the creditor an assignment is often not a preferred option because it is likely to expose the creditor to certain risks and involve it in the on-going matters needed to maintain and exploit the IP right (e.g. in granting licences, suing infringers, and maintaining registrations). Accordingly, the creditor may find that it has to grant an exclusive licence back to the borrower to enable the borrower to act of its own volition but, as noted earlier, this may imperil the nature of the mortgage as fixed security.

14.8.2 Taking security over statutory IP rights in the UK

Some IP rights exist by virtue of registration of the owner of the right. Other IP rights, whilst existing under statute, do not have a registration system. For the sake of simplicity, the following refers to domestic UK law, without reference to the expanded position under EU law. IP rights that exist in the UK by virtue of registration are trade marks (under the Trade Marks Act 1994, the 'TMA'), patents (under the Patents Act 1977, the 'PA'), and registered designs (under the Registered Designs Act 1949, the 'RDA'). Those that exist under statute but do not have a registration system are copyright (under the Copyright, Designs and Patents Act 1988,

⁴²² For the covenants to be implied the assignor must either assign 'with full title guarantee' or with 'limited title guarantee' and not use the previously common phrase 'as beneficial owner'. There is no need for the assignment to be for valuable consideration.

⁴²³ For example, when taking security in copyright the lender might seek a waiver of the author's moral rights.

⁴²⁴ One exception is business goodwill which tends to be subject to fixed security.

⁴²⁵ Particularly in relation to copyright and unregistered design rights, for the purposes of preserving priority.

the ‘CDPA’), unregistered design rights (also under the CDPA) and database rights (under the Copyright and Rights In Database Regulations 1997⁴²⁶).

14.8.2.1 Registered rights

A patent is granted for a period of 20 years, subject to payment of the necessary fees for continued registration in that period. It is personal property and security may be taken over a patent, but it must be in writing signed by both parties.⁴²⁷ Despite judicial dicta that priority is by date of registration,⁴²⁸ this is not entirely the case. Section 33(1) Patents Act 1977 provides that a later transaction (T2) has priority over an earlier transaction if the earlier transaction (T1) is not registered, and the person taking the later interest does not have knowledge of the earlier one.⁴²⁹ It does not, however, appear from the wording of the statute that T2 must be registered in order to have priority over T1.⁴³⁰ Further, this can lead to strange consequences: if T1 is not registered at the time of T2, then T1 would not be able to obtain priority over T2 by registering before T2, but this would only relate to the position between T1 and T2. If, after the time of T2, T1 registers and T2 does not, T1 will gain priority over T3 while the unregistered T2 will not (thus creating a circularity problem). Moreover, as far as the element of knowledge is concerned it is not clear whether registration of a charge over a patent or a trade mark in the company charges register⁴³¹ would be sufficient to constitute prior knowledge: while a party searching the company charges register would clearly have actual notice of a registered charge, it is not clear whether registration is constructive notice and the cautious approach would be to assume that it does not. A trade mark is personal property⁴³² capable of continued existence, subject to the periodic renewal of its registration and the requirements as to use. It may be the subject of security, which may be registered.⁴³³ The discussion about priority in relation to patents also applies to trade marks.⁴³⁴ A registered design is personal property and is valid for 25 years, subject to payment of renewal fees. It can be the subject of security.⁴³⁵ For security purposes, there is a requirement for writing⁴³⁶ and, for priority purposes, the security should be registered, since a transmission of a registered design⁴³⁷ is subject to ‘any rights vested in any other person of which notice is entered in the register of designs, or in the case of applications, notice is given to the registrar.’⁴³⁸ While, then, a later secured party takes subject to an earlier registered secured party, if the first party’s interest is not

⁴²⁶ SI 1997/3032.

⁴²⁷ PA, s 30.

⁴²⁸ *Fraser v Oystertec plc* [2003] EWHC 2787, [2004] FSR 22 [70]; *Finecard International Ltd v Urquhart Dyke & Lord* [2005] EWHC 2481 (Ch) [2006] F.S.R. 27 [15].

⁴²⁹ In *Transfer Systems v International Consultants BL O/1/05* (cited in CIFA guide to the Patents Act, 33-04) an earlier unregistered assignment had priority over a later registered assignment as the later assignee took with knowledge of the earlier assignment.

⁴³⁰ CIFA guide to the Patents Act, 33-03. See also M Bridge, L Gullifer, G McMeel and S Worthington, *The Law of Personal Property* (London, Sweet & Maxwell, 2013) 36-023.

⁴³¹ Note that the particulars which must be registered include a tickbox as to whether there is security over IP, see section 859D(2)(d) of the Companies Act 2006.

⁴³² TMA, s 22.

⁴³³ TMA, ss 24 and 25.

⁴³⁴ The relevant section is TMA, s 25(3).

⁴³⁵ RDA, s 19.

⁴³⁶ RDA, s 20.

⁴³⁷ This expressly includes an assignment, but only includes a mortgage or other security interest by implication.

⁴³⁸ Section 15B(2) Registered Designs Act 1949.

registered at the time of the second interest, it would appear that normal rules of priority apply and that this cannot be changed by subsequent registration.⁴³⁹

14.8.2.2 Unregistered rights

Copyright, unregistered design rights, and database rights, whilst existing by virtue of statute, do not have a registration system. Copyright exists, in most cases, for the life of the author etc. plus 70 years. It is personal property that is capable of assignment in writing, including the assignment of future copyright.⁴⁴⁰ There is no system for the protection of priority (although the company charges register now provides a reasonably effective means of giving notice to those who search the register) and, accordingly, the general rules should apply, so that equitable interests will rank in accordance with the date of their creation and the holder of a legal interest should take free of a prior equitable interest of which it had no knowledge. Unregistered design rights exist for a duration of either 10 years from first manufacture of the article incorporating the design or 15 years from creation. They are personal property and are capable of assignment in writing.⁴⁴¹ Database rights exist for a period of 15 years from compilation or publication. They are personal property capable of assignment in the same way as copyright.

14.8.3 Companies Act registration

Any charge, whether fixed or floating, granted by a company over any IP right is registrable in the company charges register at Companies House.⁴⁴² This is irrespective of any registration in an IP register, which means that a creditor seeking to protect its security in a patent, trade mark or a registered design ought to file in both registers. The particulars which must be delivered to Companies House include a ‘checkbox’ to indicate whether a fixed charge has been created over ‘intellectual property’ which will alert searchers to this fact without them having to read the charge instrument. The term ‘intellectual property’ is defined for this purpose to be any patent, trade mark, registered design, copyright, or design right, as well as any licence under or in respect of any such right.⁴⁴³

14.9 Taking Security over Receivables

14.9.1 The issues that arise in taking security over receivables (that is, trade debts or book debts have already been addressed, so this section refers briefly to the key steps required to take security from the perspective of a prospective secured creditor. Subject to any impediment that may be placed upon the ability of the security giver to create the security, particularly under a contractual restriction affecting its ability to dispose of its rights⁴⁴⁴, it should be possible to create security over both present and future receivables although the steps may vary depending on whether future debts are involved or not. Unlike a mortgage over existing debts, a mortgage over future

⁴³⁹ Laddie, Prescott and Vitoria, *The Modern Law of Copyright and Designs* (4th edn 2011) 56-28.

⁴⁴⁰ CDPA, ss 90 and 91.

⁴⁴¹ CDPA, ss 222 and 223.

⁴⁴² S 859A of the Companies Act 2006.

⁴⁴³ S 859D(5) of the Companies Act 2006. This is the same definition as under the former s 861(4) of the Companies Act 2006. Curiously, database rights are still not included in the definition.

⁴⁴⁴ Such contractual restrictions may become nullified if the Business Contract Terms (Restrictions on Assignment of Receivables) Regulations, are adopted, see: <https://www.gov.uk/> (last accessed August 2015). See 14.1.9.2.

receivables can only take effect in equity. If parties seek to create a legal mortgage by way of a statutory assignment of a debt, it is necessary that the assignment be absolute, of the whole debt (which must be a present debt) and in writing under the hand of the assignor with notification to the debtor.⁴⁴⁵ If the parties seek to create a mortgage by way of novation, it is necessary to effectuate the substitution of the new creditor (the mortgagee, B) for the previous creditor (the mortgagor, A): again (perhaps obviously) the debt must be a present debt. If the mortgagor and mortgagee hold accounts with the same bank, novation takes place by an in-house transfer of books of the bank. This effectively involves merely a change of the person of the creditor (from A to B). If they hold accounts with different banks, the substitution of the parties requires involvement a higher-tier bank with whom banks of both parties hold their accounts, so as to give effect to the transfer by an in-house transfer. This requires not only the change of the person of the creditor but also the change of the person of the debtor.⁴⁴⁶

An equitable assignment of book debts by way of mortgage requires fewer steps to be taken compared to legal mortgage. The mortgagor must evince a clear intention to irrevocably assign an identifiable receivable by way of mortgage. This can take place in one of three ways.⁴⁴⁷ For clarity, in what follows the intending mortgagor is referred as “A” while the prospective mortgagee is “B”. First, A may send to B a signed written transfer or A and B may conclude an agreement that A will transfer the receivable. Second, A may declare himself or appoint another as a trustee of the debt or the collected debt (debt as they are paid by the person who owes them) for B. Third, A directs the debtor to pay B, either following A and B’s previous agreement to this or this was communicated to B.⁴⁴⁸

14.9.2 Any security over receivables created by a company is registrable at Companies House except where it falls within one of the exceptions such as a financial collateral arrangement.⁴⁴⁹ If an individual who is engaged in business gives security over his book debts then it should be registered pursuant to section 344 of the Insolvency Act 1986.

14.10 Taking Security over Credit Balances and Other Obligations Owed by a Creditor

14.10.1 Charge-backs

A dilemma that has arisen concerns whether security can be taken by a creditor over the benefit of an obligation that the creditor owes to the debtor (sometimes referred to as a ‘charge back’). The creditor may wish to take security over the obligation so as to secure a debt or some other liability, particularly a contingent liability that is owed by the debtor or a third party to the creditor. In the hands of the debtor, the obligation of

⁴⁴⁵ See above 14.5.3.1.1.

⁴⁴⁶ L Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 2013 5th edn) para 3-03.

⁴⁴⁷ L Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 2013 5th edn) para 3.15-3.19.

⁴⁴⁸ *Curran v Newpark Cinemas Ltd* [1951] 1 All ER 295.

⁴⁴⁹ S 859A of the Companies Act 2006. For discussion of what constitutes a financial collateral arrangement, see above 14..7.5..

the lender is an asset, being a claim (a chose in action) that the debtor has against the creditor.⁴⁵⁰ It may be of considerable value and of good quality. On normal principles, there should be no difficulty in the asset (that is, the benefit of the claim) being provided as security to a third party for a liability that is owed to the third party.⁴⁵¹ The problem arises where the security is to be provided to the person against whom the claim is enforceable. In effect, that person is seeking to take security over its own liability. In traditional terms, this has been the subject of set-off of one claim against the other, rather than the taking of security.

14.10.1.1 Two examples will serve to illustrate the type of claim or asset that might be involved. The first is the credit balance on an account that the debtor may have with a bank which, in turn, may wish to take security over that credit balance. The second is the benefit of a life policy issued by an insurance company and held by the debtor. The insurance company may have provided credit to the policy holder or some other party (for instance, by way of a loan to purchase a house) and wish to take security over the policy.⁴⁵²

14.10.1.2 The reasons for preferring security to set-off.

There are various reasons why the creditor (the bank or the life company in the two examples given above) may wish to take security rather than be content to rely upon its rights of set-off. In the first place, a right of set-off may not exist as, for instance, where the credit balance or life policy is intended to stand as security for the obligations that are owed by a third party to the creditor, without the person holding the balance or policy incurring a personal liability by way of guarantee which could be the subject of a set-off.⁴⁵³ Secondly, set-off may not be available in an insolvency of one or other (or both) of the parties because the insolvency proceedings might take place in a foreign jurisdiction which does not permit such a set-off.⁴⁵⁴ Thirdly, set-off may not be available to cover the type of liability which is intended to be secured or there may be practical difficulties in establishing and quantifying the claims and their relative amounts for the purposes of the set-off.⁴⁵⁵ Fourthly, set-off requires mutuality as between the holders of the respective cross-claims at the time the set-off is asserted. Mutuality will be lost if one of the claims has been assigned prior to the time that it is wished to assert or apply the set-off, with the consequence that the assignee will be unable to rely upon the set-off that the assignor might have enjoyed.⁴⁵⁶ This will be a particular problem in an insolvency of the assignor, if it continues to be liable on the claim due by it.⁴⁵⁷

⁴⁵⁰ See *Foley v Hill* (1848) 2 HL Cas 28.

⁴⁵¹ See Lord Hoffmann in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, at 226–227.

⁴⁵² In this example, the problem is likely to surface if the life company seeks to assign the loan and the ‘security’ that it holds for the loan, as a claim to set-off cannot be assigned.

⁴⁵³ That was the position in *Tam Wing Chuen v Bank of Credit & Commerce Hong Kong Ltd* [1996] BCC 388 and in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214. The unusual feature in each case was that because the bank was insolvent, it did not wish to assert a right of set-off against the credit balance over which it purported to hold security.

⁴⁵⁴ As is demonstrated by the lack of insolvency set-off in Luxembourg, as discussed in *Re Bank of Credit and Commerce International SA (No 10)* [1997] Ch 213.

⁴⁵⁵ These sorts of difficulties are now commonly avoided by the use of close-out netting.

⁴⁵⁶ Although the obligor should be able to assert the set-off for its own benefit, particularly where it can rely upon equitable or transaction set-off: *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 1 WLR 578.

⁴⁵⁷ *Re City Life Assurance Co; Stephenson’s Case* [1926] 1 Ch 191, at 214.

14.10.1.3 Set-off as a topic in its own right is addressed separately below.

14.10.1.4 The conceptual impossibility argument

The dilemma referred to above was addressed initially by Millett J in *Re Charge Card Services Ltd*,⁴⁵⁸ in which his Lordship held that it was a conceptual impossibility for a party to take security over its own obligation.⁴⁵⁹ This was because the taking of security by way of mortgage would theoretically involve a re-assignment back to the security taker of its own obligation, which would have the effect of discharging that obligation. Clearly, that would not be what the parties had intended to achieve. He held that an attempt to take a charge in such circumstances would amount to no more than an agreement for contractual set-off because the secured creditor cannot sue itself, appoint a receiver to collect from itself or sell its own obligation. As an agreement for contractual set-off, it would cease to apply in the liquidation of one (or both) of the parties, although insolvency set-off could apply.⁴⁶⁰ It is interesting to note, in passing, that his Lordship applied this analysis even though the security would, if valid, have been by way of charge, rather than an assignment by way of legal or equitable mortgage.

14.10.1.5 The view that was taken in the *Charge Card* case was overturned ultimately by the decision of the House of Lords in *Re Bank of Credit and Commerce International SA (No 8)*,⁴⁶¹ in which the leading speech was delivered by Lord Hoffmann, with whom the other Law Lords who sat on the appeal agreed. Lord Hoffmann said that the conceptual impossibility argument was misconceived and that it was possible to take the security. In passing, his Lordship remarked that the law should not deny the use of a form of security which was seen to have practical utility in the banking and commercial community. In arriving at his conclusion, his Lordship looked at the essential characteristics of security. The person taking the security only has a limited entitlement in the asset that is the subject of the security, being the right to resort to it to satisfy the liability secured by it. The giver of the security retains its equity of redemption, which is its entitlement to have the asset fully restored to it when the liability has been discharged. The only difference between a creditor seeking to take security over its own liability and taking security over any other type of asset was in the method of enforcement of the security, as in the former case it will take place by a book entry, by which the asset would be appropriated against the amount of the secured liability. In all other aspects, the rights and consequences attached to the security would be the same. In particular, given the presence of the

⁴⁵⁸ [1987] Ch 150, at 175–176 (the case was the subject of an appeal, which did not deal with this aspect: [1989] Ch 497).

⁴⁵⁹ This view was followed in the single judgment of the Court of Appeal (of which Millett LJ was a member) in *Re Bank of Credit and Commerce International SA (No 8)* [1996] Ch 245, at 257–262.

⁴⁶⁰ For further discussion of conceptual problems and policy issues, which were not argued, see R Goode, *Commercial Law in the Next Millenium (the 1997 Hamlyn Lectures)* (Sweet & Maxwell 1998) 69-71.

⁴⁶¹ [1998] AC 214. It might be argued that the decision on this aspect was merely *obiter*, as the House dismissed the appeals to it by deciding that, in any event, the two sets of depositors would not be able to force the liquidators to return the deposits or to apply the rules of insolvency set-off, because the liquidators were not obliged to repay the deposits, due to the ‘flawed asset’ provisions, and because there was no mutuality between the claims due to the company in liquidation (the bank) and the claims due by it to the depositors, who were not the borrowers and had not undertaken a personal liability for payment of the claims due by the borrowers to the bank. However, the issue currently under discussion was raised and fully argued in the appeals and formed part of reasons for the decision to dismiss the appeals and, on that basis, should be regarded as being a binding authority of a unanimous decision by the House.

equity of redemption, there would not be a merger of interests, as the giver of the security retains its interest, but subject to the security. The consequence of this is that taking security over a deposit does not effect an outright re-assignment of the liability that the deposit represents. The security giver's equity of redemption serves as the point of distinction and prevents a merger of the interests from taking place.

14.10.1.6 Lord Hoffmann's analysis is based on the security being in the form of a charge. As previously discussed, the creation of a charge does not involve any concept of a conveyance or transfer of title in the charged asset and that is the clearest method of avoiding the conceptual impossibility argument. However, the analysis that his Lordship employed should also apply if the security is in the form of a legal or equitable mortgage, given the importance that he attached to the continued presence of the equity of redemption which prevents the merger of the interests of the parties and of the underlying security with the liability it secures.⁴⁶² The position, however, is not entirely clear and it is therefore highly advisable for security over a debt owed by the secured party to be drafted as a charge.

14.10.1.7 It is apparent from what he said that Lord Hoffmann saw no difficulty in the method of enforcement of this type of security being by way of application of the deposit against the secured liability, without the necessity of having recourse to the traditional methods of enforcement of security, such as by sale or (with a court order) foreclosure. He did not explain how this might be different from the position when a right of set-off is exercised, which achieves the same thing. It might be argued, in consequence, that his Lordship impliedly invented a new method for enforcing security, which would apply to this type of security. However, it is submitted that the same method of enforcement would apply if a third party took security over a deposit. It is hardly likely that the third party would have to sell the deposit to realise its security. In reality, it would simply require that the amount of the deposit should be paid to it, which it would then apply against the outstanding secured liability.

14.10.1.8 A charge over credit balance granted by a company will be registrable under section 859A of the Companies Act 2006⁴⁶³ except where it falls within the scope of Financial Collateral Arrangements (No 2) Regulations 2003, which is likely where banks or brokers conclude with their client (who is a non-natural person) a security transfer collateral agreement over the balance (which is likely to constitute "cash" for the purposes of the Regulations).⁴⁶⁴

14.10.2 Insolvency set-off relating to the deposit taken by the bank

An issue that remains outstanding concerns the relationship between a charged deposit or similar asset of the type just discussed and the rules as to insolvency set-off, which are discussed below. The context in which the question may arise is as

⁴⁶² See also the argument made in H. Beale, M. Bridge, L. Gullifer and E. Lomnicka, *The Law of Security and Title-Based Financing*, 2nd edn (Oxford: Oxford University Press, 2012) para 6.24.

⁴⁶³ Prior to 6th April 2013 a charge over a bank balance was registrable if it were floating charge or a fixed charge over book debt (under the now repealed section 860 of the Companies Act 2006). On the point whether the credit balance on a bank account could have constituted a book debt, Lord Hoffman declined to express a view. However, he did refer to the view taken in *Northern Bank Ltd v Ross* [1990] BCC 883 (which, in turn, had relied on what Lord Hoffmann had said in *Re Brightlife Ltd* [1987] Ch 200 and in *Re Permanent Houses (Holdings) Ltd* (1989) 5 BCC 151) which suggested that it was unlikely that the security would be considered to be a charge on book debts.

⁴⁶⁴ See above 14.7.6.1.

follows.⁴⁶⁵ The company (C) borrows money from bank B but seeks protection against credit risk. Three options should be considered. First, the repayment of the loan owed by C to B may be guaranteed by way of a personal guarantee given by the company director (D) who also holds a deposit account with B. The guarantee may be expressed so that D is the principal debtor as between D and B or drafted as payment on demand. Secondly, D may give security over the funds deposited with B without giving a personal guarantee. Thirdly, the company C may grant security over its funds deposited with B. In each of these three variants when the bank becomes insolvent the question arises whether D (or C) can set-off the claim for the return of the deposit against the debt owed to B. These situations will first be considered on the basis that there is no charge-back, and then the question as to whether the charge-back breaks the necessary mutuality for a set-off will be discussed.

14.10.2.1 Where the personal guarantee is drafted with a principal debtor clause, the guarantor is jointly and severally liable with the borrower to pay the borrower's debt. The guarantor's duty to pay is not contingent. If C is insolvent, there will be no insolvency set-off as there is no mutuality, but the bank can claim against D on the guarantee. If D or the bank is insolvent, there is an automatic set-off of the deposit against the obligation while discharging the borrower's (C's) repayment obligation. If the bank is insolvent, the depositor (D) will then be left to prove as an unsecured creditor for the remaining amount of the deposit. If the personal guarantee is payable on demand, that fact that the debt is contingent is no longer an obstacle for insolvency set-off to apply, whether it is D or the bank who is insolvent: the current Insolvency Rules 1986 allow set-off in relation to contingent debts owed both by and to the insolvent party, although in the latter case, the liability is only accelerated to the extent of the set-off.⁴⁶⁶ The liquidator or administrator undertakes the quantification of the debt unless the contingency occurs before the account is taken.⁴⁶⁷

14.10.2.2 Where the depositor (D) creates a security over its deposit held with bank without giving a personal guarantee, insolvency set-off of the deposit against the debt is not available whether it is D or the bank who is insolvent.⁴⁶⁸ This is because the debts are not owed from the same party: deposit is a debt owed by B to D while the loan is a debt owed by C to B. This means there is no mutuality of debts, which is strictly required for set-off.⁴⁶⁹ To allow otherwise would defy the *pari passu* principle.⁴⁷⁰

14.10.2.3 The more difficult and thus far unresolved question arises where the depositor (granting a security over a deposit held with the bank) and the debtor are the same person. If the debtor is insolvent, the bank might not wish insolvency set-off to apply, as it does, automatically at the commencement of insolvency proceedings. The bank might wish to until it can be sure that all of the liabilities that are covered by its security have crystallised, matured, and been dealt with and discharged to its

⁴⁶⁵ This is based on *MS Fashions Ltd v Bank of Credit and Commerce International SA* [1993] Ch 425, 430 (Hoffmann LJ).

⁴⁶⁶ See rr.2.85(5) (in relation to administration) and 4.90(5) (in relation to liquidation) of the Insolvency Rules 1986.

⁴⁶⁷ Section 322(3) of the Insolvency Act 1986 (in relation to bankruptcy) and Insolvency Rules 1986, r.2.81, applicable to set-off by virtue of r.2.85(5) and r.4.86 in relation to liquidation.

⁴⁶⁸ *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214.

⁴⁶⁹ See Lord Hoffmann in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, at 223.

⁴⁷⁰ See *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758.

satisfaction, especially if some are contingent. While a liquidator or administrator will take into account contingencies eventuating before the date on which the account is taken, (the hindsight principle) it will have to estimate the value of debts remaining contingent at that point. Even if the bank can delay the moment of calculation, though, it cannot delay it for ever: at some point the company will be wound up and dissolved. Other reasons for not wishing to rely on insolvency set-off could be that the debt and the deposit are in different currencies, and the exchange rate at the date of commencement of insolvency proceedings⁴⁷¹ was not favourable to the bank.

14.10.2.4. The question of whether a charge-back is subject to insolvency set-off (which applies automatically and would not enable the bank to have the choice referred to in the last paragraph) is unresolved⁴⁷² and complex. It splits into two parts, both of which are relevant. First, it is usually the case that where a debt is the subject of a security interest, the mutuality necessary for insolvency set-off is broken to the extent of the security interest (but exists as to any balance).⁴⁷³ It is not clear why this reasoning should not apply when the security holder is the debtor: the dual capacity in which the bank acts (debtor and security holder) could be said to break the necessary mutuality. Second, as the debt owed by the depositor is secured, the controversy (discussed below⁴⁷⁴) as to whether insolvency set-off applies when one debt is secured arises. It is clear that where the debt owed to the insolvent party is secured, this can be the subject of insolvency set-off.⁴⁷⁵ Thus, when the bank is insolvent, the only reason why insolvency set-off should not apply is the lack of mutuality referred to above. Here it would be unfortunate if some form of set-off did not apply, since otherwise the (insolvent) bank could enforce its security in full, leaving the depositor to prove for its debt. If the lack of mutuality were to prevent insolvency set-off, though, the bank could still be said to have taken its security interest subject to the right of the depositor to set off its debt,⁴⁷⁶ since it knew of that right at the time when it took its security interest. **Where the depositor is insolvent, it is far less clear that insolvency set-off applies, since where a debt owed by the insolvent party is secured, there is a reasonably strong argument that it does not.**⁴⁷⁷ When this conclusion is coupled with the lack of mutuality mentioned above, it has the result that the bank does have a choice whether to enforce its security, or to surrender its security and rely on insolvency set-off. In many cases the outcome will be the same, since the charge would be enforced by book entry. Further, if the bank's charge could be said to be floating, then the insolvency consequences would make it unattractive for the bank to rely on it in preference to insolvency set-off. In the insolvency of the bank, the liquidator or administrator would wish to argue that the insolvency set-off did not apply. This is because the bank could then claim the full amount of the debt due to it, and the depositor would have to prove for the whole amount of the deposit.

⁴⁷¹ This is generally the date in relation to which the exchange rate is calculated, see Rule 4.91 Insolvency Rules 1986.

⁴⁷² Lord Hoffmann referred to the debate but did not comment in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, 225

⁴⁷³ *Re City Life Assurance Co; Stephenson's Case* [1926] 1 Ch 191, at 214. See 14.11.3.3 below.

⁴⁷⁴ 14.11.3.3.1

⁴⁷⁵ *Ex p Barnett, re Deveze* (1874) LR 9 Ch App 293, 295

⁴⁷⁶ Probably both legal and equitable set-off.

⁴⁷⁷ See the arguments made in 14.11.3.3.1

14.10.3 ‘Flawed asset’ provisions⁴⁷⁸

A ‘flawed asset’ provision is one which provides that a liability due by A to B (for instance, a liability of A as a bank to repay a deposit that has been placed with it by B) may be withheld and will not fall due for payment or discharge whilst any liability remains outstanding that is owing and undischarged by B (or a third party) to A. It will probably also provide for A to have the right to set off one liability against the other once they have both been fully established. Such provisions were developed with a view to overcoming the difficulty created by the decision in the *Charge Card* case; in fact, a ‘triple cocktail’ provision developed which included a set-off, a flawed asset and a charge-back, in the hope that at least one of these devices would be effective. Although they could not, in themselves, enable A to treat the deposit placed with it as security, it was intended that they might have much the same effect, as A would be able refuse to repay the deposit whilst any liability which the deposit ‘secured’ remained outstanding and unsatisfied, particularly where the outstanding and unsatisfied liability was that of a third party.

14.10.5.1 Flawed asset provisions have been considered in very few cases.⁴⁷⁹ In *Re Bank of Credit and Commerce International SA (No 8)*,⁴⁸⁰ the provision was considered by the Court of Appeal, who held that the charge-back provision was ineffective, but took the view that the bank was sufficiently protected by the flawed asset, since it would not be obliged to repay the deposit until the borrower’s obligation was paid. In that case, the depositor had no personal liability to the bank. The deposit was simply intended to ‘secure’ the obligation of a third party to the bank. The Court of Appeal confirmed that the ‘flaw’ in the deposit continued despite the liquidation of the bank or the depositor, although in the latter situation, the court thought it would be likely that the depositor’s trustee or liquidator would wish to come to an arrangement with the bank, by which the bank would apply the deposit, so that the insolvency practitioner could obtain any balance remaining for the benefit of the depositor’s general body of creditors. Lord Hoffmann in the House of Lords agreed with the analysis of the Court of Appeal and did not add any additional commentary.⁴⁸¹

14.10.5.2 The interrelationship between a flawed asset provision and insolvency set-off is not straightforward. As mentioned above, no obligation to repay the deposit arises until the ‘secured’ obligation is paid in full, and this remains the position even in the insolvency of either party. Insolvency set-off, though, applies to contingent debts as well as present (and future) debts, and it is the duty of the liquidator or administrator to value the debts when effecting the set-off, taking account of anything that has happened since the commencement of the insolvency proceedings. Where the depositor is the person owing the ‘secured’ obligation and is insolvent, the obligation will not be paid (in full) by any method other than set-off; the deposit will never become payable and the liquidator will have to value it at zero. Although insolvency set-off is therefore theoretically available as there is mutuality, its

⁴⁷⁸ See L Gullifer ‘Flawed Assets’ in G. Virgo and S. Worthington *Commercial Remedies* (Cambridge University Press, forthcoming).

⁴⁷⁹ See *Fraser v Oystertec* [2004] EWHC 1582; *Re Lehman Brother (Europe) (In Administration)* [2012] EWHC 2997 (Ch) [47] – [48] as well as the *BCCI* case.

⁴⁸⁰ [1996] Ch 245.

⁴⁸¹ [1998] AC 214, at 225.

operation will leave the entire amount of the loan as a provable debt. The bank, however, is protected by not having to repay the deposit, but it might be in the liquidator's interest to pay the full amount of the loan in order to enable him to claim the full amount of the deposit from the bank, which gives the same economic effect as if there had been a set-off or an enforced security interest. Where it is the bank that is insolvent, the 'secured' obligation is owed by B, a solvent party, and so will be paid. Therefore, the likely solution is that the contingent debt (the bank's obligation to pay) should be valued in full, and insolvency set-off should apply.⁴⁸² However, as where B is insolvent, there are not mutual debts due at the same time: it is at the moment when the loan obligation is paid that the contingent debt arises, and so technically insolvency set-off could be said not to apply. The position is very unclear, and it could be in the depositor's interest to bargain for a provision that the bank's obligation to repay arises automatically if it (the bank) becomes insolvent, though there is a danger that such a provision could be vulnerable under the anti-deprivation principle.

14.10.5.3 Where the depositor is not the person owing the 'secured' obligation, insolvency set-off will not apply as there is no mutuality, unless the depositor has guaranteed the obligation. If that is the case, a combination of the analysis in the paragraphs 14.10.2.1, 14.10.2.2 and in the previous paragraph will apply. Where the depositor is insolvent, any application of insolvency set-off will normally result in the flawed asset being valued at zero and the whole of the 'secured' obligation being a provable debt. Where the bank is insolvent, as mentioned, the position is unclear.

14.10.5.3 In view of the decision of the House of Lords that true security can be taken over such a deposit, it is unlikely that a creditor would now need to rely on a 'flawed asset' provision.⁴⁸³

14.11 Set-off

14.11.1 Set-off is the means by which opposing cross-claims between parties are applied or netted against each other to arrive at a net balance that is payable one way or the other. Whilst it is not, strictly speaking, a matter of security, the subject of set-off is important and relevant in the context of this chapter because it can be very similar in its consequences, and sometimes amount to in practical terms, to effective 'security'. This is because set-off can have the effect of reducing the risk exposure that a creditor has towards its counterparty, particularly in the event of a default by, or an insolvency of, the counterparty. There are, in addition, a number of other benefits that may accrue to a creditor which has a right of set-off. These include, first, the ease of valuation of the benefit it enjoys from the set-off; secondly, the ease with which a set-off can be exercised under contractual set-off and insolvency set-off, by a simple application of one claim against the other; and, thirdly, regulatory benefits which may allow a bank to treat the risk exposure referable to its counterparty as the net balance

⁴⁸² The analysis in the text derives some support from the judgment of the Court of Appeal in *MS Fashions Ltd v Bank of Credit and Commerce International (In Liquidation)* (No 2) [1993] Ch 425. In relation to the High Street Services appeal, repayment of the deposit was conditional upon payment in full to the bank (at 445). Notwithstanding this Dillon LJ held that insolvency set off applied (at 448).

⁴⁸³ However, if an agreement does not amount to a charge, it may be a contractual flawed asset arrangement, creating restrictions on the use of the contents of accounts, which could be relevant where a third party judgment creditor seeks a final third party debt order requiring third party to pay the creditor; the court need not exercise its discretion to make such an order under Civil Procedure Rules 1998/3132 Part 72, r.72.2, see: *Oystertec plc* [2004] EWHC 1582.

after taking into account the set-off, rather than the gross figure of its exposure before such an account is taken. In a more commercial context, set-off may have the effect of providing an abatement in the price of goods and services that have been supplied, so as to accommodate the loss because of defective performance. It may also avoid the necessity of pursuing separate proceedings for recovery of the cross-claim.

14.11.1.1 In discussing the subject, it is necessary to distinguish between rights of set-off that are exercisable before the insolvency of one of the parties (or both of them) and the position as to mandatory insolvency set-off that arises in the winding up or bankruptcy of a party (and sometimes in the administration of a party). It will also be necessary to refer to the consequences where a party assigns a claim which would otherwise have been subject to a set-off between the original parties.

14.11.2 Pre-insolvency set-off

Outside the context of insolvency, the matters for examination concern the right of a party to assert, as against the other party, a legal set-off, an equitable set-off, and a contractual set-off, as well as its right to rely on a contractual provision which denies to the other party the right to exercise a set-off.⁴⁸⁴ It will also be necessary to consider the special rules that apply in the case of negotiable instruments.

*14.11.2.1 Legal set-off*⁴⁸⁵

Legal set-off is a procedural device that arises in litigation for the convenience of avoiding a multiplicity of suits.⁴⁸⁶ It allows the defendant in the proceedings to plead in its defence the cross-claim that it has against the claimant. It is not necessary that there should be any connection between the claim and the cross-claim. The set-off may only be asserted, however, if the cross-claim is both liquidated (or capable of precise calculation or valuation) and due at the times when the defence is filed and when judgment is given.⁴⁸⁷ It is also necessary that the claim and the cross-claim should be between the same people and in the same right, that is, a requirement for mutuality as between the parties to the set-off.⁴⁸⁸

14.11.2.1.1 When considering the parameters in which legal set-off may take place, it could be said that the set-off is wide in one sense and narrow in another. It is wide in the sense that there need be no connection between the claim of the claimant

⁴⁸⁴ While an alternative terminology and classification proposed by P Wood, *English and International Set-Off* (1989) has been met with some enthusiasm in the academia (see L Gullifer, *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 5th edn 2013) and by courts, the traditional labels appear to persist (see e.g. *Fearn's (trading as Autopaint International) v Anglo-Dutch Paint & Chemical Co Ltd* [2010] EWHC 2366 (Ch), [2011] 1 WLR 366; *Stemcor UK Ltd v Global Steel Holdings Ltd* [2015] EWHC 363 (Comm); [2015] 1 Lloyd's Rep. 580); hence, their use here.

⁴⁸⁵ See Hoffmann LJ in *Aectra Refining & Marketing Inc v Exmar NV* [1994] 1 WLR 1643, at 1649–1653; Lord Hoffmann in *Stein v Blake* [1996] AC 243, at 251; and Clarke LJ in *Glencore Grain Ltd v Agros Trading Co Ltd* [1999] 2 Lloyd's Rep 410, at 415–417.

⁴⁸⁶ The procedural nature of this type of set-off is relevant in the context of conflict of laws, as discussed at Chap 4.

⁴⁸⁷ It is still possible to plead the set-off even though the amount of the cross-claim might be disputed, in which case the court will have to determine the correct amount: *Aectra Refining & Marketing Inc v Exmar NV* [1994] 1 WLR 1643.

⁴⁸⁸ A lack of mutuality at a beneficial level will prevent the set-off: see Sir George Jessell MR in *Re Whitehouse & Co* (1878) 9 ChD 595, at 597. Parke B in *Briscoe v Hill* (1842) 10 M&W 735, at 738, said that it is not possible to plead a joint liability against a several debt because the debts were not due in the same right.

in the proceedings and the cross-claim of the defendant, provided the requirement for mutuality is met. It is narrow in the sense that the cross-claim must be liquidated or capable of precise calculation and it must be due at the time it is asserted and when judgment is given.

14.11.2.2 Equitable set-off

There are at least three different types of equitable set-off that might be relevant in a commercial context. They are transaction set-off, set-off as between a claim and cross-claim at a beneficial level which would not be available at law, and the set-off that is available to a debtor whose debt has been assigned. It is also important to consider the circumstances in which a right to equitable set-off may be denied.

14.11.2.2.1 Transaction set-off⁴⁸⁹ Transaction set-off, which arises as a substantive defence to a claim in litigation, is wide and narrow in the opposite way to legal set-off. It is wide in the sense that the cross-claim does not have to be for a liquidated amount, as it can include a claim for damages to be assessed.⁴⁹⁰ It is narrow in the sense that it applies where it would be manifestly unjust to refuse to allow the set-off. For equitable set-off to apply there must be an inseparable connection between the claim and the cross-claim, as they must arise out of the same course of dealings and transactions.⁴⁹¹ It seems that the connection will be inseparable when two elements are present: a formal element of close connection, decided on the basis of “principle not discretion”, and a functional element of whether it would be unjust to enforce the claim without accounting for the cross-claims.⁴⁹² When claim and cross-claim arise from one contract the formal element is likely to be satisfied but need not be.⁴⁹³ By the same token, the formal element can be met even though the claim and the cross-claim arise under different contracts. The courts have taken various factors into account when establishing this, for example the closeness of subject matter⁴⁹⁴ or whether the contracts have been negotiated independently or together.⁴⁹⁵ The parties can sometimes establish a close connection (or not) by the way in which the claims are treated.⁴⁹⁶ Establishing the presence of the functional element is even more fact specific, depending often on factors such as the strength of claims⁴⁹⁷ and the conduct

⁴⁸⁹ As to a legal right of set-off and the distinction between that and equitable or transaction set-off, see Hoffmann LJ in *Aectra Refining & Marketing Inc v Exmar NV* [1994] 1 WLR 1643, at 1649–1653; Clarke LJ in *Glencore Grain Ltd v Agros Trading Co Ltd* [1999] 2 Lloyd’s Rep 410, at 415–417; Buxton LJ in *Smith v Muscat* [2003] EWCA Civ 962; [2003] 1 WLR 2853, at [37]–[45]; and *Benford Ltd v Lopecan SL* [2004] EWHC 1897 (Comm), [2004] 2 Lloyd’s Rep 618.

⁴⁹⁰ The amount of the cross-claim must then be assessed as part of the proceedings.

⁴⁹¹ See Potter LJ in *Bim Kemi AB v Blackburn Chemicals Ltd* [2001] EWCA Civ 457, [2001] 2 Lloyd’s Rep 93.

⁴⁹² See Rix LJ in *Geldorf Metaalconstructie NV v Simon Carves Ltd* [2010] EWCA Civ 667, [2010] 4 All ER 847 who stresses, however, that these elements are not tests.

⁴⁹³ Two claims under the same contract may not be sufficiently connected to meet the requirement: see Lord Hobhouse in *Government of Newfoundland v Newfoundland Ry Co* (1888) 13 App Ca 199 (PC) 212–213. See also *Sankey v The Helping Hands Group plc* CA, 5 Oct 1999.

⁴⁹⁴ *Bim Kemi AB v Blackburn Chemicals Ltd* [2001] EWCA Civ 457, [2001] 2 Lloyd’s Rep 93, [35]; *Geldorf Metaalconstructie NV v Simon Carves Ltd* [2010] EWCA Civ 667, [2010] 4 All ER 847 [47].

⁴⁹⁵ *Geldorf Metaalconstructie NV v Simon Carves Ltd* [2010] EWCA Civ 667 paras 10 and 44.

⁴⁹⁶ *Geldorf Metaalconstructie NV v Simon Carves Ltd* [2010] EWCA Civ 667, [2010] 4 All ER 847 [46]; *Addax Bank BSC (c) v Wellesley Partners LLP* [2010] EWHC 1904 (QB), [44]–[45].

⁴⁹⁷ *Esso Petroleum Co Ltd v Milton* [1997] 1 WLR 938, 952 (Thorpe LJ); *Star Rider Ltd v Innpreneur Pub Co* [1998] 1 EGLR 53; *Antiquesportfolio.com.plc v Rodney Fitch & Co Ltd* [2001] ECDR 5 (Ch D).

of the parties.⁴⁹⁸ , There are more specific lines of authority relevant to this chapter. For example, it has been held that where a provision for a contractual set-off was void because it created an unregistered charge, equitable set-off was not available.⁴⁹⁹ Another example is that a mortgagor cannot unilaterally appropriate the amount of a cross-claim, even if it is both liquidated and admitted (and *a fortiori* if unliquidated), in the discharge of the mortgage debt.⁵⁰⁰ This would have the effect of discharging the mortgaged debt. Parties may expressly agree otherwise.

14.11.2.2.1.1 Transaction set-off will usually arise where the original claim is for a liquidated sum and the set-off is in respect of an unliquidated cross-claim for damages. Nonetheless, the right to equitable set-off can also be asserted where both the claims are for unliquidated damages,⁵⁰¹ and can be relied upon where both claims are liquidated.

14.11.2.2.1.2 It used to be said that a claim to transaction set-off goes to ‘impeach’ the original claim.⁵⁰² Such a description was thought unhelpful, so the nature of this type of set-off is now thought to have shifted away from impeachment and towards the ‘inseparable connection’ test. Thus, it is now reasonably clear that this type of set-off right is considered to be a substantive defence, rather than merely a procedural one. This has implications for the treatment of the two claims as a matter of conflict of laws.⁵⁰³ However, while it operates as a substantive defence, it takes effect at the time the judgment is given on the claim or agreement is made and does not operate automatically to extinguish or reduce the claim before the judgment.⁵⁰⁴ One effect of it being a substantive defence, is that where a payment is made taking account of transaction set-off, a self-help remedy for underpayment is not triggered. If a creditor ignores the asserted set-off and goes ahead with the self-help remedy, he acts ‘at his peril’.⁵⁰⁵ If the set-off is upheld, the creditor will be liable for wrongfully doing whatever the self-help remedy would otherwise entitle him to do.⁵⁰⁶ The debtor must, however, assert the set-off before it can act as a defence in this way,⁵⁰⁷ although its cross-claim need not be definitively quantified providing that the assertion is made reasonably and in good faith.⁵⁰⁸

⁴⁹⁸ *Bluestorm Ltd v Portvale Holdings Ltd* [2004] EWCA Civ 289, [2004] HLR 49

⁴⁹⁹ *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend* [2001] UKHL 58, [2002] 1 AC 336 [78].

⁵⁰⁰ *Samuel Keller Holdings Ltd v Martins Bank Ltd* [1971] 1 WLR 43, 47-48 (Megarry J); *Mobil Oil Co Ltd v Rawlinson* (1982) 43 P & CR 221, *Day v Tiuta International Ltd* [2014] EWCA Civ 1246.

⁵⁰¹ See Potter LJ in the *Bim Kemi AB v Blackburn Chemicals Ltd* [2001] EWCA Civ 457, [2001] 2 Lloyd’s Rep 93, [21]–[23].

⁵⁰² *Rawson v Samuel* (1841) Cr & Ph 161, 179.

⁵⁰³ See the discussion at Chap 4.

⁵⁰⁴ *Fearns v Anglo-Dutch Paint and Chemical Co* [2010] EWHC 2366 (Ch), [2011] 1 WLR 366; *Stemcor UK Ltd v Global Steel Holdings Ltd, Pramod Mittal* [2015] EWHC 363 (Comm), [2015] 1 Lloyd’s Rep 580.

⁵⁰⁵ *Federal Commerce & Navigation Co Ltd v Molena Alpha Inc (The "Nanfri")* [1978] 2 QB 927, 974; *Equitas Ltd & Anor v Walsham Bros Co Ltd* [2013] EWHC 3264 (Comm) [179].

⁵⁰⁶ *Federal Commerce & Navigation Co Ltd v Molena Alpha Inc (The "Nanfri")* [1978] 2 QB 927, 974; *Fuller v Happy Shopper Markets Ltd* [2001] 1 WLR 1681.

⁵⁰⁷ *Equitas Ltd & Anor v Walsham Bros Co Ltd* [2013] EWHC 3264 (Comm) [179].

⁵⁰⁸ *Federal Commerce & Navigation Co Ltd v Molena Alpha Inc (The "Nanfri")* [1978] 2 QB 927, 975; *Santiren Shipping Ltd v Unimarine SA; (The "Chrysovalandou Dyo")* [1981] 1 Lloyd’s Rep. 159.

14.11.2.2.1.3 There is considerable overlap between abatement of the price of goods or services for breach of warranty, and equitable set-off,⁵⁰⁹ so that both are often referred to collectively as ‘transaction set-off’. The former, however, arises at common law as, for instance, under section 53(1)(a) of the Sale of Goods Act 1979..

14.11.2.2.2 Equitable set-off at the beneficial level This type of set-off arises where set-off would not be available between claims at common law, because the claims are not as between the same parties. It is allowed as a form of equitable set-off where, at the beneficial level, the claims are really between the same parties.⁵¹⁰ For instance, it would arise where A is indebted to B and C is indebted to A, but where B is acting as trustee of C with respect to the debt due to B by A. A set-off would not be available at common law, but it would arise in equity.

14.11.2.2.2.1 The onus is on the person that wishes to assert the set-off to establish the true relationship as between the trustee and the beneficiary. It is not sufficient for that person simply to assert that one of its counterparties is acting as a trustee, if it cannot establish that the trustee is acting for the other counterparty.⁵¹¹

14.11.2.2.3 Set-off in the context of assignment or security The issue that arises at this point is the effect that an assignment of a debt may have on the rights to set-off that a debtor had or would have enjoyed against the assignor, and whether the debtor can assert those rights against the assignee. In other words, whether the debtor can continue to assert, as against the assignee, a set-off that it would have been entitled to assert against its original creditor, in the situation where its debt has been assigned so that, at least superficially, the element of mutuality has been broken. This matter is addressed in Chapter 12. The discussion there is equally applicable in the context of security being taken over the debt. Indeed, *Business Computers Ltd v Anglo-African Leasing Ltd*,⁵¹² which is one of the leading cases, concerned the effect on the debtor’s rights of set-off following upon its receipt of a notice of the crystallisation of a floating charge, the event of crystallisation being treated for these purposes as being equivalent to an assignment of the debt.

14.11.2.2.4 Denying equitable set-off It would appear that a claim to equitable set-off cannot be asserted by a defendant where the claim against the defendant arises from the defendant’s wrongful action, such as due to its wrongful conversion of goods or breach of a statutory obligation.⁵¹³ It has also been held that where money is paid to a person in the position of a trustee or fiduciary, to be used for a specific purpose and the purpose cannot be achieved, then (in the absence of an agreement to the contrary) that person will not be allowed to set-off against its obligation to refund the money some other claim that it may have against the original payer of the money.⁵¹⁴

⁵⁰⁹ *Sim v Rotherham Metropolitan BC* [1987] 1 Ch 216, 257 – 259.

⁵¹⁰ *Cochrane v Green* (1860) CB (NS) 448; *Thornton v Maynard* (1875) LR 10 CP 695; *Bhagal v Punjab National Bank* [1988] 2 All ER 296.

⁵¹¹ *Bhagal v Punjab National Bank* [1988] 2 All ER 296; *Saudi Arabian Monetary Agency v Dresdner Bank AG* [2004] EWCA Civ 1074, [2005] 1 Lloyd’s Rep 12.

⁵¹² [1977] 1 WLR 578.

⁵¹³ See Lords Hoffmann and Scott in *Smith (Administrator of Cosslett (Contractors) Ltd v Bridgend CBC* [2001] UKHL 58; [2002] 1 AC 336, at [34]–[36] and at [76]–[78], respectively.

⁵¹⁴ *Re Niagara Mechanical Services International Ltd* [2001] BCC 393.

14.11.2.3 Contractual set-off

It is open to the parties to an agreement to provide for the availability of set-off by either or both of them in circumstances that would not arise as a legal or equitable set-off. For instance, they may agree that the set-off might be applied outside the parameters of litigation, so that a party could advance its right to set-off to a contractual date for payment under a contract, rather than having to wait for litigation to be commenced. If one of the parties is a bank, they might agree that it would be entitled to exercise a right or set-off outside the confines that normally apply to the implied right that a banker has to combine accounts (see below). The parties could also agree that the set-off might be applied to claims that would arise in different countries or as between claims in different currencies.⁵¹⁵

14.11.2.3.1 It is also possible for them to agree that one of them could set-off against the other a claim due to one of them by a third party, such as another company in the same group as one of the contracting parties. However, if it is sought to apply a set-off against a claim made by the third party, that party would have to agree. Thus, A and B may agree that A could set-off a debt due to it by C against a debt due to B by A. However, A and B could not agree, without C's agreement, that A could avoid having to pay a debt due by it to C by setting-off a debt due by B to A. Of course, it is perfectly possible for a number of parties to enter into a multilateral agreement providing for netting and set-off on a multilateral basis between them all as, for instance, by having a settlement of debts on a periodic basis through a clearing house or central body and establishing an ultimate balance due as between the participants.

14.11.2.3.2 Under English domestic insolvency law, contractual rights of set-off cease to be available upon the bankruptcy or liquidation of one of the parties to the contract,⁵¹⁶ because the mandatory rules of insolvency set-off apply, whatever the contract might provide.⁵¹⁷ However, there are statutory savings for the settlement of market contracts and the operation of the rules of recognised investment exchanges and clearing houses pursuant to sections 158 and 159 of the Companies Act 1989,⁵¹⁸ as well as other savings under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999⁵¹⁹ and, with respect to close-out netting, under the Financial Collateral Arrangements (No 2) Regulations 2003.⁵²⁰

14.11.2.3.3 A contractual set-off agreement may be valuable, however, in the context of a cross-border insolvency of a party within the EU. Article 6 of the EU Insolvency Regulation,⁵²¹ which is repeated in the relevant legislation concerning

⁵¹⁵ In which case it would be necessary to provide for a mechanism for calculating the conversion of one currency into another so as to achieve the set-off.

⁵¹⁶ And, in limited circumstances, an administration of a party.

⁵¹⁷ *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] AC 785; *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 1 WLR 758; *Re Maxwell Communications Corp PLC (No 2)* [1993] 1 WLR 1402.

⁵¹⁸ And, pursuant thereto, the Financial Markets and Insolvency Regs 1991 (SI 1991/880).

⁵¹⁹ SI 1999/2979.

⁵²⁰ SI 2003/3226.

⁵²¹ The Regulation No 1346/2000 on insolvency proceedings (EC1346/2000 OJ L160/1 30/6/2000). Art 6 is discussed in Chap 5. For the new regulation entering into force on 26 June 2017, see article 9 of the Regulation (EU) 2015/848 of 20 May 2015 on insolvency proceedings (recast) (OJ L 141/19 of 5/6/2015).

insolvent credit institutions⁵²² and insurance undertakings,⁵²³ provides for the preservation of rights of set-off where the law that governs the insolvent debtor's claim would permit the set-off, despite the opening of insolvency proceedings under the law of a Member State which might not acknowledge such rights. In addition, the validity and effectiveness of a netting agreement to which an EU or EEA insolvent credit institution is a party, is governed by the law that governs the agreement.⁵²⁴

14.11.2.4 *The banker's right of set-off*

By virtue of the relationship between banker and customer, the banker has a right in certain situations to combine or net the balances on the separate accounts that it holds for a customer so as to achieve a net balance due one way or the other. Although there is some doubt as to the basis of the right, it is submitted that it arises as a form of implied right of contractual set-off. This is because it springs from the contractual relationship between the parties and it is a right in favour of the bank, which it can determine to exercise if it wishes, rather than an automatic and continuous netting that arises in favour of both parties.⁵²⁵

14.11.2.4.1 This form of set-off should be distinguished from the situation that arises on a single running account, to which debit and credit entries are made on a continuous basis as, for instance, on an overdraft account. The making of the debit and credit entries to the account does not give rise to the operation of set-off; rather, there is a single relationship with a balance being struck from time to time to show what is due one way or the other.⁵²⁶

14.11.2.4.2 The implied right of the bank to combine accounts arises where the balance on each account is due and payable, as would be the case between two current accounts.⁵²⁷ It will not arise whilst the customer's liability to the bank is contingent or payable in the future,⁵²⁸ nor where one account is a current account and the other is a deposit or term account,⁵²⁹ at least until the accounts have reached maturity or where the bank has an express right to combine the accounts. In light of the decision of the House of Lords in *Miliangos v George Frank (Textiles) Ltd*,⁵³⁰ to the effect that a debt in a foreign currency may properly be treated as a debt and is no longer to be treated as a claim for a mere commodity, it should now be possible for a bank to set off balances in different currencies.

14.11.2.4.3 The implied right to set-off depends upon mutuality as between the entitlement in the accounts. Accordingly, if the accounts are maintained in the same name but the bank is on notice that the beneficial entitlement in one of the accounts

⁵²² Art 23 of the EC Directive on the reorganisation and winding up of credit institutions (EC 2001/24 OJ L125 5/5/2001). The Directive has been implemented in the UK by the Credit Institutions (Reorganisation and Winding Up) Regulations 2004 (SI 2004/1045, as amended by SI 2007/830).

⁵²³ EC Directive on the reorganisation and winding up of insurance undertakings (EC 2001/17 OJ L110 20/4/2001). The Directive has been implemented in the UK by the Insurers (Reorganisation and Winding Up) Regulations 2004 (SI 2004/353, as amended by SI 2004/546).

⁵²⁴ Art 25 of EC 2001/24.

⁵²⁵ See, for instance, Lord Denning MR in *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1971] 1 QB 1, at 34 and Buckley J in *Re EJ Morel Ltd* [1962] Ch 21, at 31.

⁵²⁶ See Buckley LJ in *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1971] 1 QB 1, at 46, and Millett J in *Re Charge Card Services Ltd* [1987] Ch 150, at 174.

⁵²⁷ *Garnett v McKewan* (1872) LR 8 Ex 10.

⁵²⁸ *Jeffryes v Agra & Masterman's Bank* (1866) LR 2 Eq 674.

⁵²⁹ *Bradford Old Bank v Sutcliffe* [1918] 2 KB 833.

⁵³⁰ [1976] AC 443.

rests in a third party, the bank will not be entitled to combine the accounts.⁵³¹ By contrast, if the bank can demonstrate that an account, although maintained in the name of one person, is held beneficially for another customer, it should be able to set-off the entitlement on that account against a liability of that customer to the bank, but the onus rests on the bank to demonstrate the connection.⁵³²

14.11.2.5 Precluding the exercise of rights to set-off

Just as it is possible to enhance or create rights of set-off by contract, so it is also possible by contract to reduce or withdraw those rights,⁵³³ although this is subject to certain statutory limitations which will be mentioned. As a matter of interpretation, the intention to preclude or limit the exercise of the right must be clearly expressed.⁵³⁴ Accordingly, an agreement that required payment to be made ‘without any deduction’,⁵³⁵ or ‘without discount’,⁵³⁶ were held not to preclude the exercise of a right of set-off, as was an agreement that a party’s payment obligations were unaffected ‘by any matter whatsoever’.⁵³⁷

14.11.2.5.1 As with a contract which confers rights of set-off, an agreement that precludes or restricts the exercise of such rights will cease to have effect upon the bankruptcy or liquidation of one of the parties.⁵³⁸ This rule, though clear, is controversial, since a restriction on set-off may benefit the insolvent party, and the Cork Committee on Insolvency Law and Practice⁵³⁹ recommended in 1982 that contracting out of insolvency set-off should be permitted, but no legislation has yet been forthcoming.

14.11.2.5.2 Statutory limitation There are two areas of potential statutory limitation to the effectiveness of a contractual provision that purports to preclude a party from asserting a right of set-off (a ‘no-set off clause’). The first arises under the Unfair Contract Terms Act 1977 (UCTA), which applies to business-to-business contracts and the other arises under the Consumer Rights Act 2015 (CRA), governing contracts with consumers. The latter entered into force on 1 October 2015 and replaced Unfair Terms in Consumer Contracts Regs 1999⁵⁴⁰ (UTCCR) and UCTA insofar as it applies to contracts with consumers.

14.11.2.5.3 UCTA More detailed discussions of UCTA will be found in Chapters 9 and 15. What follows here is intended to provide a summary of the provisions of UCTA that are of immediate relevance to the present discussion.

⁵³¹ *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567.

⁵³² *Saudi Arabian Monetary Agency v Dresdner Bank AG* [2004] EWCA Civ 1074, [2005] 1 Lloyd’s Rep 12.

⁵³³ *Coca-Cola Financial Corp v Finsat International Ltd* [1998] QB 43; *John Dee Group Ltd v WMH (21) Ltd* [1998] BCC 972; *International Lease Finance Corp v Buzz Stansted Ltd* [2004] EWHC 292 (Comm).

⁵³⁴ *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] 1 AC 689 (HL), 717–18, 722–3; *Re Kaupthing Singer and Friedlander Ltd (Isle of Man) Ltd* [2009] EWHC 740 (Ch), [2009] 2 Lloyd’s Rep 154, [16]

⁵³⁵ *Connaught Restaurants Ltd v Indoor Leisure Ltd* [1994] 1 WLR 501.

⁵³⁶ *Compania Sud Americana de Vapores v Shipmair BV, The Teno* [1997] 2 Lloyd’s Rep 289.

⁵³⁷ *BOC Group plc v Centeon LLC* [1999] 1 All ER (Comm) 970.

⁵³⁸ *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] AC 785.

⁵³⁹ Cmnd 8558 (1982).

⁵⁴⁰ SI 1999/2083.

14.11.2.5.3.1 Section 3 of UCTA provides that where a contracting party is dealing on the other party's standard terms of business,⁵⁴¹ that other party cannot by a contractual term exclude or restrict his own liability for breach of the contract, nor purport to render no performance at all or a substantially different performance than was reasonably to be expected under the contract, except (in either case) in so far as the term satisfies the requirement of reasonableness in section 11 of UCTA. This is supplemented by section 13(1) of UCTA, the salient part of which provides as follows,

To the extent that this Part of this Act [which includes both section 2 and section 3 of the Act] prevents the exclusion or restriction of any liability it also prevents—

- (a) making the liability or its enforcement subject to restrictive or onerous conditions;
- (b) excluding or restricting any right or remedy in respect of the liability, or subjecting a person to any prejudice in consequence of his pursuing any such right or remedy;
- (c) excluding or restricting rules of evidence or procedure . . .

14.11.2.5.3.2 In *Stewart Gill Ltd v Horatio Myer & Co Ltd*⁵⁴² the Court of Appeal held that paragraph (b) applied to a no set-off clause which prevented the exercise by a customer of a right of equitable set-off or counterclaim in an instalment payment contract, where faulty goods had been supplied. The customer had wished to set off its counterclaim for the loss it had suffered due to the goods being defective, against the instalments that it was due to pay under the contract. It was held that the right of set-off or counterclaim was a right or remedy that the customer would normally have been entitled to assert against the supplier. The clause prevented it from exercising the right. It would also subject the customer to prejudice, in that the clause would have the effect of forcing the customer to pursue its claim against the supplier separately, rather than being able to use the more effective and immediate right of set-off. An attempt by the supplier to limit or restrict its liability for the defective goods would have fallen within section 3 of UCTA. Accordingly, section 13 was engaged and the anti-set-off clause could only be saved if it met the requirement of reasonableness. That requirement had not been satisfied, as it could not be reasonable to prevent the customer in any and all circumstances from seeking to assert a right of set-off including, for instance, where it might have made an over-payment under an earlier instalment.⁵⁴³

14.11.2.5.3.3 It is possible that much the same approach might be taken towards a no set-off clause which related to a cross-claim that a party might wish to assert concerning loss due to the negligence of the other party. Section 2 of UCTA applies to attempts by a contractual provision (or by a non-contractual notice) to limit or exclude liability for negligence. Assuming that the liability does not concern death or personal injury, any such provision (or notice) will only be effective if it satisfies the requirement of reasonableness in section 11 of UCTA.

⁵⁴¹ As to dealing on standard terms of business, see *St Albans City and District Council v International Computers Ltd* [1996] 4 All ER 481.

⁵⁴² [1992] QB 600.

⁵⁴³ For a recent example of a case where an anti-set-off clause was held reasonable, see *University of Wales v London College of Business Ltd* [2015] EWHC 1280 (QB) at 97 (the clause was reasonable for the following reasons: both were commercial entities; the clause was clear; this was a common provision meant to facilitate cash flow; the lack of mutuality could be explained as only one party was supposed to be paying; and the clause was sensible in commercial context.)

14.11.2.5.3.4 On the other hand, in *Governor & Co of the Bank of Scotland v Singh*⁵⁴⁴ it was held that section 3 (and therefore section 13) of UCTA would not normally apply to a no set-off clause in a guarantee that operated against the guarantor. This was because a guarantee is usually a form of unilateral contract under which it was the guarantor that had contractual obligations to the lender. The lender had no contractual obligations to the guarantor. It was, accordingly, difficult to see how a no set-off clause could be said to fall within section 3, as there were no obligations of the lender towards the guarantor under the contract which could be excluded, restricted, or abrogated.

14.11.2.5.3.5 It was also said in the same case that, assuming sections 3 and 13 of UCTA were engaged, a no set-off clause might, nonetheless, satisfy the requirement of reasonableness under section 11 of UCTA, which had to be judged by the circumstances as at the time the guarantee was entered into. The purpose of a no set-off clause in a guarantee was to ensure that the guarantor's payment obligations, which arose because of the borrower's default in making payment, could not be deferred or diminished by disputes concerning a cross-claim that the guarantor might allege it had against the lender (in that case, the cross-claim was for 'reflective loss' arising from the economic loss suffered by the guarantor due to the failure of the principal debtor which, it was alleged, was the fault of the lender). The lender wants its money, which it should have received from the borrower, without further delay. It was significant in that case that the clause did not prevent the guarantor from pursuing a claim separately if it wished to do so and so, in that sense, the clause did not have the effect of excluding or restricting the lender's liability. For the same reason, such clauses are not subject to the strict rules that are applied to the construction of exclusion clauses.⁵⁴⁵

14.11.2.5.3.6 By reference to the guidance given in Schedule 2 to UCTA,⁵⁴⁶ the clause was held to be reasonable. The guarantor had received independent legal advice on the meaning and effect of the document and, through its control of the principal debtor, it wanted the debtor to be able to borrow from the lender, which could only be achieved if it gave the guarantee. The guarantor knew that the guarantee would cover the borrowing. It could control the amount of the debt that was guaranteed. In so far as the clause prevented the guarantor from purporting to set off a reflective loss claim, it was likely that such a claim would be brought at a time when the guarantor had lost its control of the borrower because of the latter's insolvency and it was not unreasonable for the lender to seek to protect itself in that situation.⁵⁴⁷

14.11.2.5.4 CRA Part 2 (sections 61-76) of the CRA governs unfair terms and notices. Section 61 of the CRA⁵⁴⁸ provides that the Part applies in relation to contracts between a trader and a consumer, as defined in section 2 of the CRA.⁵⁴⁹ "Trader" means a person acting for purposes relating to that person's trade, business, craft or

⁵⁴⁴ Unreported, HHJ Kershaw QC, sitting in the High Court in Manchester, 17/6/2005.

⁵⁴⁵ See the approach taken by Parker LJ in the Court of Appeal in *Continental Illinois National Bank & Trust Co of Chicago v Papanicolaou* [1986] 2 Lloyd's Rep 441, at 444.

⁵⁴⁶ As to the relevance of which outside the express circumstances where the schedule applies, see *Stuart-Smith LJ in Stewart Gill Ltd v Horatio Myer & Co Ltd* [1992] QB 600 (CA) 608.

⁵⁴⁷ For other examples of similar reasoning, see *F. G. Wilson (Engineering) Ltd v John Holt & Co (Liverpool) Ltd* [2012] EWHC 2477 (Comm), [2013] 1 All ER (Comm) 223 [99]; *Deutsche Bank (Suisse) SA v Gulzar Ahmed Khan* [2013] EWHC 482 (Comm), [329]

⁵⁴⁸ Cf previously regulation 4(1) of UTCCR providing that 'The Regulations apply in relation to unfair terms in contracts concluded between a seller or supplier and a consumer'.

⁵⁴⁹ S2 *juncto* s76(2) of CRA.

profession, whether acting personally or through another person acting in the trader's name or on the trader's behalf.⁵⁵⁰ "Consumer" means an individual acting for purposes that are wholly or mainly outside that individual's trade, business, craft or profession. This seems wider than the previous understanding of a consumer⁵⁵¹ facilitating inclusion of individuals who act closely but still primarily outside their business etc. Section 62 of CRA provides a test when a contractual term (which need not be individually negotiated, unlike previously under UTCCR⁵⁵²) or a notice is unfair and provides that where it is found to be unfair – it is void. Either a term or a notice are unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract to the detriment of the consumer.⁵⁵³ In determining whether a term is fair nature of the subject matter of the contract should be taken into account and reference should be made to all the circumstances existing when the term was agreed and to all of the other terms of the contract or of any other contract on which it depends. Schedule 2 to the Act gives a non-exhaustive indication of unfair terms.⁵⁵⁴ Paragraph 2 of that Schedule includes a no set-off clause that applies to a debt owed to the trader against any claim which the consumer may have against the trader with respect to a total or partial non-performance or inadequate performance.⁵⁵⁵

14.11.2.5.4.1 The CRA will apply, as the UCCTR did, to the provisions of standard form contracts for the provision of financial services to consumers. Accordingly, a no set-off clause in such a contract, by which the consumer is denied the opportunity to assert a set-off against a debt due to the provider of the services will fall within the scope of the Act. However, the CRA does not change the position which existed under the UCCTR in relation to a no set-off provision in a guarantee given by an individual with respect to a facility provided by a bank to the principal debtor. In a case⁵⁵⁶ decided under UCCTR it was held that such a guarantee would not normally fall within the scope of the UCCTR. The characteristic of the guarantee was that it was the guarantor who was undertaking obligations under the contract towards the lender, rather than the other way around. Hence, the effect of the no set-off clause could not be said to be causing any significant imbalance in the parties' rights and obligations arising under the contract, because the obligations under that contract only went in one direction, from the consumer towards the lender. The same considerations apply under CRA given that the test for unfairness relates to imbalance in the parties' rights and obligations. Schedule 2 of the CRA, as did Schedule 2 of the UCCTR includes no set-off clauses in the context of attempts to limit or exclude a consumer's rights or remedies with respect to breaches by a trader of its obligations to the consumer under the contract. On the same basis, as already mentioned with respect to section 3 of UCTA, there were no relevant obligations of the beneficiary towards the guarantor under the contract which would be affected by the clause. However, it should be noted that the list of terms in Schedule 2 of each of the CRA and UCCTR is non-exhaustive list. It could be argued that the test for unfairness ought to look at the

⁵⁵⁰ Cf previously regulation 3(1) of UTCCR referring to a seller or supplier who was defined as a natural or legal person acting for the purposes of his or its trade, business, or profession.

⁵⁵¹ Cf previously regulation 3(1) of UTCCR: a natural person who is acting outside his trade, business, or profession.

⁵⁵² Previously regulation 5(1) of UTCCR.

⁵⁵³ Previously regulation 5(1) of UTCCR.

⁵⁵⁴ Previously Sch 2 of UTCCR.

⁵⁵⁵ Previously para 1(b) of Sch 2 of UTCCR.

⁵⁵⁶ *Governor & Co of the Bank of Scotland v Singh*, unreported, HHJ Kershaw QC, sitting in the High Court in Manchester, 17/6/2005.

balance of parties' rights and obligations globally, irrespective of who undertakes (the greater) burden of obligations. Arguably, the test was devised not only to ensure that the trader does not eschew obligations too lightly but also to see that the obligations imposed on the consumer are not too burdensome. If this is correct, there should be no objection on the grounds of the scope of the CRA preventing a no set-off clause in a guarantee given by a consumer to a trader from being tested for unfairness.

14.11.2.6 Negotiable instruments

Because a negotiable instrument generates an autonomous payment obligation, which is entirely separate from the underlying transaction in relation to which it was given, and the fact that it is treated as being equivalent to cash, it is not possible for a party that is liable on the instrument to set off an unliquidated cross-claim that it may have against its obligation to make payment on the instrument, even if the cross-claim relates to the underlying transaction and is against an immediate party to the instrument.⁵⁵⁷ Nonetheless, it should be possible to set off a liquidated cross-claim arising on a total or partial failure of consideration or fraud relating to the underlying transaction, except against a holder in due course of the instrument.⁵⁵⁸ The reasoning in this paragraph has also been applied to direct debits.⁵⁵⁹

14.11.2.6.1 It has been suggested that a party which is liable on a negotiable instrument might be entitled to assert a legal set-off against a holder of the instrument if it is sued by the holder on the instrument,⁵⁶⁰ but this would appear to be contrary to the general approach that is taken towards such an instrument.⁵⁶¹

14.11.2.6.2 It has also been suggested that, in an exceptional case, a defendant which has been sued on a negotiable instrument and is unable to assert its cross-claim by way of set-off might be entitled to obtain a stay on enforcement of a judgment on the instrument, pending the hearing of its cross-claim,⁵⁶² but that has been doubted.⁵⁶³

14.11.2.6.3 It should at least be possible to assert a cross-claim so as to resist a petition for winding up that is presented on the basis of non-payment of a negotiable instrument.⁵⁶⁴

14.11.3 Insolvency set-off

This type of set-off applies in the bankruptcy or winding up of a party and, sometimes, in an administration of a party,⁵⁶⁵ where there are outstanding cross-liabilities as between the insolvent debtor and its creditor. The effect of the set-off is

⁵⁵⁷ *James Lamont & Co Ltd v Hyland Ltd* [1950] 585; *Nova (Jersey) Knit Ltd v Kammgarn Spinnerei GmbH* [1977] 1 WLR 713.

⁵⁵⁸ *Ibid*; *Cebora SNC v SIP (Industrial Products) Ltd* [1976] 1 Lloyd's Rep 271.

⁵⁵⁹ *Esso Petroleum Co Ltd v Milton* [1997] 1 WLR 938, 952–3 (Thorpe LJ), 954 (Sir John Balcombe) (Simon Brown LJ dissenting); *Courage Ltd v Crehan* [1999] ECC 455 (CA), [77]

⁵⁶⁰ See Hirst J in *Hongkong & Shanghai Banking Corp v Kloeckner & Co AG* [1990] 2 QB 514, at 524.

⁵⁶¹ See Waller LJ in *Safa Ltd v Banque du Caire* [2000] 2 Lloyd's Rep 600, at 606.

⁵⁶² *Barclays Bank Ltd v Aschaffenburg Zellstoffwerke AG* [1967] 1 Lloyd's Rep 387.

⁵⁶³ *Cebora SNC v SIP (Industrial Products) Ltd* [1976] 1 Lloyd's Rep 271.

⁵⁶⁴ *Re Bayoil SA* [1999] 1 WLR 147.

⁵⁶⁵ The provisions as to set-off in administration are to be found in Rule 2.85 of the Insolvency Rules 1986. They only apply if the administrator is to make a distribution pursuant to para 65 of Sched B1 to the Insolvency Act 1986. The provisions of Rule 2.85 correspond to those contained in Rule 4.90 of the Insolvency Rules 1986, so the commentary will concentrate on the latter rule. It should be noted, though, that there is likely to be a longer period between the relevant date and the date the account is taken in the case of administration.

that a balance should be struck as at the relevant date⁵⁶⁶, such as the date of the making of the bankruptcy or winding-up order or the date of the resolution to wind up, which will result in either a net amount due to the creditor, for which it can prove in the insolvency, or a net sum payable by the creditor to the insolvent estate.⁵⁶⁷

14.11.3.1 The rules of insolvency set-off in bankruptcy and winding up are mandatory and self-executing,⁵⁶⁸ even if the other party does not lodge a proof of debt, and it is not possible to contract out of them.⁵⁶⁹ Their effect is extensive, being wider in scope than both the rules as to legal set-off and those for transaction set-off, as they apply to all claims as between the parties and not just those that would ground an entitlement to assert either a legal set-off or a transaction set-off.

14.11.3.2 The rules as to bankruptcy set-off are contained in section 323 of the Insolvency Act 1986. The rules as to set-off in a winding up are contained in Rule 4.90 of the Insolvency Rules 1986. Prior to 2005, they were to substantially the same effect. Rule 4.90 was effectively replaced by a new rule in 2005,⁵⁷⁰ and much of the previous difficulty in interpretation of the old rule, particularly as to the determination of what might be 'due' as between the parties, was addressed by the new rule. However, the wording of section 323 of the Insolvency Act 1986 was not changed⁵⁷¹ and so it is necessary to provide a summary of the law as it has developed in relation to the old provision. The new form of Rule 4.90 reflects much of what the case law had eventually determined was the position under the old wording. Rule 4.90 is set out at a later point in this discussion.

14.11.3.3 Before embarking upon a summary of the relevant statutory provisions of insolvency set-off in bankruptcy and in winding-up, it is useful to provide a general overview the conditions which must be met before the rules of insolvency set-off can apply. These have been developed considerably by courts and what follows is a general overview. First, the claim by the solvent party must be a provable debt at the date of account⁵⁷², so it cannot for example be time-barred⁵⁷³ or debarred by a rule

⁵⁶⁶ Rules 2.85(2) and 4.90(2) of the Insolvency Rules 1986.

⁵⁶⁷ See Hoffmann LJ, sitting at first instance, in *MS Fashions Ltd v Bank of Credit and Commerce International SA* [1993] Ch 425 (affd [1993] Ch 439) and Lord Hoffmann in *Stein v Blake* [1996] AC 243. Once the mandatory account is taken, the trustee in bankruptcy is entitled to assign the net balance like any other chose in action, see: *Enterprise Managed Services Ltd v Tony McFadden Utilities Ltd* [2009] EWHC 3222 (TCC), [2011] 1 BCLC 414.

⁵⁶⁸ There is a departure from this principle in respect of set-off in an administration, as the rules will only apply if the administrator has given notice of his intention to make distributions to creditors.

⁵⁶⁹ *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] AC 785. See also Lord Hoffmann in *Stein v Blake* [1996] AC 243, at 253-254. While the creditor cannot agree with the debtor to contract out of its insolvency set-off, it may be possible for the creditor's claim to fall outside the rules of insolvency set-off, for example for lack of a provable debt (a creditor may agree not to prove in debtor's insolvency, see *Kitchen's Trustee v Madders* [1950] Ch 134) or mutuality if the parties in all circumstances conduct their dealings as in fact not mutual (it is not likely to be sufficient that the parties merely intended the dealings not to be mutual), for instance, the creditor may declare itself as a trustee of the debt: see Jonathan Parker J in *RE ILG Travel Ltd (In Administration)* [1996] BCC 21, 48-49.

⁵⁷⁰ In consequence of the Insolvency (Amendment) Rules 2005 (SI 2005/527).

⁵⁷¹ A relatively minor amendment to this section is introduced under Enterprise and Regulatory Reform Act 2013, Sch 19 para 27 on a date yet to be appointed, see immediately below.

⁵⁷² See Lord Hoffmann in *Re West End Networks Ltd, Secretary of State v Frid* [2004] UKHL 24, [2004] 2 AC 506 at para 13.

⁵⁷³ *Pott v Clegg* (1847) 16 M & W 321.

against double proof.⁵⁷⁴ While a provable debt may be future or contingent, it must accrue or arise out of an obligation incurred⁵⁷⁵ before the relevant date (i.e. the date on which the company goes into liquidation or enters administration or the date of the commencement of bankruptcy).⁵⁷⁶ Secondly, insolvency set-off requires mutuality of what is due at the beneficial level as between the parties to the set-off,⁵⁷⁷ so that, for instance, an assignment by one of the parties of its claim against the other before the commencement of its insolvency will destroy the mutuality of the claim as between the original parties,⁵⁷⁸ although the debtor whose debt has been assigned may be entitled to assert its original rights of set-off⁵⁷⁹ against the assignee (on the basis that the assignor could only assign what he had, which was a debt subject to set-off). The requirement of “mutual debts” requires the cross-claim to be a commensurable debt, arising out of an obligation incurred before the relevant date⁵⁸⁰, between the same people in the same capacity.⁵⁸¹ It is not material how those debts arose, whether by contract, statute or tort, voluntarily or by compulsion.⁵⁸² Subject to some rather difficult and imprecise qualifications, mutuality would also be destroyed where the creditor has assigned the debt due to it by way of mortgage or has charged it by way of fixed charge.⁵⁸³ Thirdly, the claim against the insolvent must arise from mutual dealings, so claim based on wrongdoing, such as an insolvent’s claim for conversion of its property⁵⁸⁴, cannot be subject to insolvency set-off. Fourthly, and linked with mutuality, is the requirement that claims on both sides must be such as will in their nature terminate in debts, so for example a trust beneficiary cannot set off his claim to the trust fund against an insolvent trustee.⁵⁸⁵

⁵⁷⁴ The rule prevents two creditors from proving against the insolvent company for what is substantially the same debt, for example a surety cannot prove against the principal debtor (in respect of its right of indemnity under the guarantee) in competition with the principal creditor. The rule also prevents the surety from competing with the principal creditor indirectly by setting off his right to an indemnity against any separate debt owed by the surety to the principal debtor. The basis of the rule against double proof was explained by Robert Walker J in *In re Polly Peck International plc* [1996] 2 All ER 433, 442; a rule against double proof excludes the rule under *Cherry v Boulton* (1839) 4 My & Cr 442 (as applied in *In re Melton* [1918] 1 Ch 37 (CA)) that (1839) 4 My & Cr 442, see *Mills v HSBC Trustee (CI) Ltd* [2011] UKSC 48.

⁵⁷⁵ The term “obligation incurred” has been clarified and given a wide meaning by the decision of the Supreme Court in *Re Nortel Companies* [2013] UKSC 52, see in particular paras 76-77, providing three criteria for determining whether an obligation arising out of a non-contractual source such as statute or tort falls within the definition.

⁵⁷⁶ See section 382 of the Insolvency Act 1986 and rules 12.3 and 13.12 of the Insolvency Rules 1986.

⁵⁷⁷ As to which, see *Re West End Networks Ltd, Secretary of State v Frid* [2004] UKHL 24, [2004] 2 AC 506.

⁵⁷⁸ *Re City Life Assurance Co; Stephenson’s Case* [1926] 1 Ch 191, at 214.

⁵⁷⁹ This will usually be legal set-off rights that the debtor has until notice of the assignment and equitable set-off arising at any time, see *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 1 WLR 578.

⁵⁸⁰ Rule 4.90(2)(d) of the Insolvency Rules 1986; see for example *HMRC v Millichap* (unreported) [2011] CLY 1876.

⁵⁸¹ *Secretary of State for Trade and Industry v Frid* [2004] UKHL 24.

⁵⁸² *Re DH Curtis (Builders) Ltd* [1978] Ch 162, approved in *Secretary of State for Trade and Industry v Frid* [2004] UKHL 24.

⁵⁸³ See Derham, *The Law of Set-Off* (4th edn, 2010) at paras 11.37–11.51. See discussion above in relation to charges taken over bank deposits 14.10.2.

⁵⁸⁴ *Smith (Administrators of Cosslett (Contractors) Ltd) v Bridgend CBC* [2002] 1 AC 336 para 35 (Hoffmann LJ).

⁵⁸⁵ *Lehman Brothers International (Europe) (In Administration) v CRC Credit Fund Ltd* [2009] EWHC 3228 (Ch) para 331 (Briggs J), appealed and reversed but not as to this point (CA [2010] EWCA Civ;

14.11.3.3.1 There is some controversy about whether secured claims are automatically subject to insolvency set-off, or whether the secured party has a choice whether to rely on its security or on set-off. If the insolvent party is the secured creditor, the position is clear: insolvency set-off applies.⁵⁸⁶ Where it is the non-insolvent party who is secured, one view is that insolvency set-off operates automatically unless the secured creditor has already enforced its security by the onset of insolvency proceedings.⁵⁸⁷ Another view is that the secured creditor has a choice either to enforce its security, in which case insolvency set-off will not apply, or to prove in the liquidation.⁵⁸⁸ On this view, the secured solvent party who relies on his security is not a ‘creditor of the company proving or claiming to prove for a debt in the liquidation’ as required by r 4.90.⁵⁸⁹ Arguably, the position of such a secured creditor is the same as where a creditor agrees not to prove for its debt, in which case the debt is not a provable debt and cannot be the subject of insolvency set-off.⁵⁹⁰ The default position set out by the rules is that a secured creditor enforces its security outside insolvency, and only proves for the balance (if any): it needs to make a positive choice to surrender its security to prove for the entire amount due.⁵⁹¹ Thus, unless that choice is made, the secured creditor does not fall within r 4.90, and has the right to choose whether to enforce its security or to rely on insolvency set-off (which will involve surrendering its security).⁵⁹²

14.11.3.4 *Set-off in bankruptcy*

Section 323 provides as follows:

- (1) This section applies where before the commencement of the bankruptcy there have been mutual credits, mutual debts or other mutual dealings between the bankrupt and any creditor of the bankrupt proving or claiming to prove for a bankruptcy debt.⁵⁹³

[2012] UKSC 6); *Re Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch) para 55 (Briggs J).

⁵⁸⁶ *Ex p Barnett, re Deveze* (1874) LR 9 Ch App 293, 295

⁵⁸⁷ R Goode, *Principles of Corporate Insolvency Law* (4th edn, London: Sweet & Maxwell, 2011) 9-12; L Ho, ‘Book Review’ [2008] *Journal of International Banking and Financial Law* 426. See also *Totty, Moss & Segal on Insolvency* (London: Sweet & Maxwell, looseleaf), H10-09.

⁵⁸⁸ *Re Norman Holding Co Ltd* [1991] 1 WLR 10; *Stewart v Scottish Widows and Life Assurance Society plc* [2005] EWHC 1831 (QB), [185] (appealed [2006] EWCA Civ 999, but not on this point). See also *Re Bank of Credit and Commerce International SA (In Liquidation) (No 8)* [1996] Ch 245, 256, L Gullifer and P Pichonnaz, *Set-off in arbitration and commercial transactions* (OUP, 2014) 12.86 and Derham, *The Law of Set-Off* (4th edn, 2010), 6.178.

⁵⁸⁹ Rule 2.85 and Insolvency Act 1986, s 323 are in similar terms.

⁵⁹⁰ *Kitchen’s Trustee v Madders* [1950] Ch 134.

⁵⁹¹ See rules 2.72(3)(vii), 2.83, 4.75(1)(e), and 4.88, Insolvency Rules 1986.

⁵⁹² This argument is supported by some commentators, see Sheelagh McCracken, *The Bankers’ Remedy of Set-Off* (3rd edn, London: Bloomsbury Professional, 2010), 295–7; Derham, *The Law of Set-Off* (4th edn, 2010) 6.178; S Majumdar, ‘Insolvency set-off and security: anomaly or principled exception?’ (2009) 11 JIBFL 652.

⁵⁹³ There are some exclusions as to what constitutes a provable debt, for example a liability pay child support maintenance to any person is not a debt or liability: see section 382(5) of the Insolvency Act 1986.

- (2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set-off against the sums due from the other.
- (3) Sums due from the bankrupt to another party shall not be included in the account taken under subsection (2) if that other party had notice at the time they became due that a bankruptcy petition⁵⁹⁴ relating to the bankrupt was pending.
- (4) Only the balance (if any) of the account taken under subsection (2) is provable as a bankruptcy debt or, as the case may be, to be paid to the trustee as part of the bankrupt's estate.

14.11.3.4.1 Section 323, which concerns set-off in bankruptcy, is a re-enactment of the rules that had applied under section 31 of the Bankruptcy Act 1914. It requires an account to be taken of what is 'due' as between the bankrupt and the creditor arising from the 'mutual credits, mutual debts or other mutual dealings' between the parties prior to the commencement of the insolvency proceedings (the commencement of the bankruptcy being the date of the bankruptcy order).

14.11.3.4.2 The principal difficulty that had arisen under the section concerned unquantified or contingent and unascertained liabilities of the bankrupt to the other party which had existed before the bankruptcy but had not crystallised into an actual liability for an ascertained amount prior to the bankruptcy. It was unclear whether such claims should be taken into account as being due in computing the set-off and, if so, how that should be done. At the same time, it had been decided that contingent and unascertained claims due to the insolvent debtor by the other party could not be taken into account if they had not crystallised and matured into quantified liabilities before the end of the bankruptcy.⁵⁹⁵ This is changed in the new form of Rule 4.90.

14.11.3.4.3 In a series of decisions, particularly in the period since the mid-1980s, the courts have held that it is not necessary that the debt or other obligation of the insolvent debtor which is to be set-off should have been actually due and payable as well as quantified prior to the date of the commencement of the bankruptcy or winding up. Lords Hoffmann and Millett have played a significant role in those decisions. It has been held that it is sufficient that there had been a liability at that date which had crystallised into an actual monetary claim after the commencement of the insolvency proceedings or which could otherwise be anticipated and valued.⁵⁹⁶ It was also possible to take into account events that had occurred after the date of the commencement of the insolvency to ascertain the correct amount of the liability.⁵⁹⁷

14.11.3.4.4 By way of example, the principles established in those cases have applied where there was a pre-existing contract which was breached after the commencement of the insolvency proceedings.⁵⁹⁸ The principle has also applied where a guarantor has claimed an indemnity from an insolvent debtor with respect to

⁵⁹⁴ The Enterprise and Regulatory Reform Act 2013, Sch 19 para 27 (not yet in force) extends the exclusion to debts in relation to which the other party had notice that proceedings on a bankruptcy application relating to the bankrupt were ongoing.

⁵⁹⁵ See Lord Hoffmann in *Stein v Blake* [1996] AC 243, at 253.

⁵⁹⁶ See Millett J in *In re Charge Card Services Ltd* [1987] Ch 150; Lord Hoffmann in *Stein v Blake* [1996] AC 243; and Lord Hoffmann in *Re West End Networks Ltd, Secretary of State v Frid* [2004] UKHL 24, [2004] 2 AC 506.

⁵⁹⁷ Sometimes referred to as the 'hindsight principle'. Lord Hoffmann explained the application of the principle in *Wight v Eckhardt Marine GmbH* [2003] UKPC 37, [2004] 1 AC 147.

⁵⁹⁸ *In re Asphaltic Wood Pavement Co Ltd* (1885) 30 ChD 216.

a payment made under a guarantee, where the guarantee had been given before the debtor's insolvency, even though the payment under it was made after the commencement of the insolvency proceedings.⁵⁹⁹ Of course, the surety must have a claim which it could prove in the debtor's insolvency but for the set-off, so if the surety has not made any payment under its guarantee then the rule against double proof would operate to preclude the surety submitting a proof and so the set-off could not arise.⁶⁰⁰

14.11.3.5 Set-off in a winding up

As already said, much of the case law on insolvency set-off is now reflected in the new form of Rule 4.90, which concerns set-off in a winding up. The Rule provides as follows:

- (1) This Rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.
- (2) The reference in para. (1) to mutual credits, mutual debts or other mutual dealings does not include—
 - (a) debts arising under obligations incurred after the creditor knew of the summoning of a meeting of creditors or the presentation of a petition for winding up;
 - (b) debts arising under obligations incurred with notice of steps for a preceding administration of the debtor;
 - (c) debts arising under obligations incurred in such an administration;
 - (d) debts acquired by assignment or otherwise after the winding up or preceding administration began or which were acquired with notice of steps to achieve such a winding up or administration.
- (3) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set-off against the sums due from the other.
- (4) A sum shall be regarded as being due to or from the company for the purposes of para. (3) whether—
 - (a) it is payable at present or in the future;
 - (b) the obligation by virtue of which it is payable is certain or contingent; or
 - (c) its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion.
- (5) Rule 4.86 enables the liquidator to estimate the value of any debt which, by reason of its being subject to any contingency or for any other reason, does not have a certain value.⁶⁰¹

⁵⁹⁹ *In re Moseley-Green Coal and Coke Co Ltd* (1865) 12 LT (NS) 193. See also Lord Hoffmann in *Re West End Networks Ltd, Secretary of State v Frid* [2004] UKHL 24, [2004] 2 AC 506.

⁶⁰⁰ See *Re Fenton* [1931] 1 Ch 85 and Lord Hoffmann in *Re West End Networks Ltd, Secretary of State v Frid* [2004] UKHL 24, [2004] 2 AC 506.

⁶⁰¹ This rule that the liquidator (or administrator, under rule 2.81 of the Insolvency Rules 1986) is in a position to take into account events that would occur after the relevant date when taking account for purposes of insolvency set-off is said to reflect the so-called principle of hindsight.

- (6) Rules 4.91 to 4.93 provide for converting debts which: are in foreign currencies⁶⁰²; are periodical in nature; or bear interest.
- (7) Rule 11.13 provides a method of ascertaining the value of debts which the creditor proved but which are payable in the future (there is a formula for reduction of such debts).
- (8) Only the balance (if any) of the account owed to the creditor is provable in the liquidation. Alternatively, the balance (if any) owed to the company shall be paid to the liquidator as part of the assets except where all or part of the balance results from a contingent or prospective debt owed by the creditor and in such a case the balance (or that part of it which results from the contingent or prospective debt) shall be paid if and when that debt becomes due and payable.
- (9) In this Rule, ‘obligation’ means an obligation however arising, whether by virtue of an agreement, rule of law or otherwise.

14.11.3.5.1 The previous law as to the expansive interpretation of the words, ‘mutual credits, mutual debts or other mutual dealings’ will continue to apply to those words as used in paragraph 1, so that the Rule will apply to the existence of mutual cross-obligations from which the claims to be set-off arose, howsoever they may have arisen.

14.11.3.5.2 Paragraph (2) is wider than the equivalent provision in section 323(3) of the Insolvency Act 1986.⁶⁰³ In particular, section 323(3) does not contain any equivalent to paragraph 2(d) of Rule 4.90.⁶⁰⁴

14.11.3.5.3 Paragraphs (4) and (9) emphasise the width in scope of the claims and liabilities that should be taken into account. It should be noted that paragraph (4) makes it clear that, unlike the old law, contingent and future claims due to the insolvent company by the other party should be taken into account. Paragraphs (5), (6), and (7) make provision as to the methods of valuing contingent and future claims and claims in foreign currencies. This might lead to an injustice if it eventuates, particularly after the winding up has been completed, that an incorrect valuation was placed on a claim.

14.12 *Quistclose* Trusts

14.12.1 The *Quistclose* case

The decision of the House of Lords in *Quistclose Investments Ltd v Rolls Razor Ltd*⁶⁰⁵ caused quite a stir. The leading speech in the case was delivered by Lord Wilberforce. In his decision, Lord Wilberforce recognised the possibility of the co-existence of legal and equitable remedies to protect a lender for the repayment of its loan. In addition to the right to sue at law for the repayment of the loan, a lender which had

⁶⁰² Rule 4.91 (and also 2.86 in relation to administration) of the Insolvency Rules 1986 is disapplied under regulation 14 of the Financial Collateral Arrangements (No 2) Regulations 2003 in favour of the contractual provisions unless the arrangement provides for an unreasonable exchange rate. This applies where a party to a financial collateral arrangement, or a party to a close-out netting provision in a financial collateral arrangement, goes into liquidation or administration.

⁶⁰³ Which, in any event, refers only to the creditor having notice of a pending bankruptcy petition concerning the insolvent debtor.

⁶⁰⁴ 14.11.3.5(2) above.

⁶⁰⁵ [1970] AC 567.

provided funds to a borrower to be used for some specific purpose might also be able to pray in aid the law of trusts for the lender's protection in the event that the proceeds of the loan could not be used for that purpose. Such protection might be valuable in the event of the insolvency of the borrower.

14.12.1.1 In the *Quistclose* case, the loan had been provided to enable a company to pay its shareholders a dividend which had been declared but which the company did not have the funds to pay. Before the date for payment of the dividend, the company went into voluntary liquidation, which meant that the dividend could not lawfully be paid. Although there was no evidence that the parties to the transaction had contemplated that their arrangements would constitute anything other than the usual relationship of debtor and creditor, the lender sought to recover its loan by asserting that the proceeds of the loan, which had been paid into a separate account at the borrower's bank, were held on trust for the lender.

14.12.1.2 Lord Wilberforce spoke of such arrangements giving rise in equity 'to a relationship of a fiduciary character or trust, in favour, as a primary trust, of the [shareholders] and, secondarily, if the primary trust fails, of the [lender]'. In the event that the primary trust is carried out and the proceeds of the loan are used for the agreed purpose for which they were provided, then the lender would simply be left with its common law rights as a creditor to sue for repayment of the loan if it was not repaid. In the event of the borrower's insolvency, the claim for repayment would suffer along with all the other claims of the unsecured creditors. If the primary trust could not be achieved and failed, so that the moneys were not applied for the relevant purpose, then the secondary trust would protect the lender, which could achieve repayment as the beneficial owner of the funds. The secondary trust arose because the money was to be held separate for a particular purpose and was not to be used for any other purpose. Not only is this a valuable right in the event of the borrower's insolvency but it might also prevail over the competing interests of third parties who are on notice of the lender's rights, as indeed was the case in the *Quistclose* case where the bank, which was holding the funds, was denied a right of set-off against those funds for its exposure to the company on facilities it had provided.

14.12.2 Other cases

The decision in the *Quistclose* case has been followed and applied in numerous cases, not just in relation to loans of money but also in connection with other payments made for some specific purpose. For instance, in *Carreras Rothman Ltd v Freeman Mathews Treasure Ltd*,⁶⁰⁶ the *Quistclose* case was invoked in relation to a payment made by a recipient of advertising services to the provider of those services, so as to enable the services provider to meet disbursements owing by it to third parties for work done in advertising the products of the services recipient. The services provider became insolvent before the money had been applied and the liquidator asserted that the money was part of the insolvent's estate, available to meet the claims of the general body of its creditors. The services recipient was able to rely upon the *Quistclose* case to defeat the liquidator, although it is not entirely clear if it did so to force the funds to be used for payment of the third parties' claims (of which it had taken an assignment) or for repayment to it of the funds on the basis that they had not been used for the agreed purpose for which they had been provided.

⁶⁰⁶ [1985] Ch 207.

14.12.3 The type of trust

Trusts along the lines of the authority in the *Quistclose* case are sometimes referred to as ‘Quistclose Trusts’, as if they were a special class of trust. This reflects the difficulties that have been experienced in seeking to fit this type of trust within the established and orthodox categories of trust as traditionally understood by English law. Not the least of those difficulties concerns the manner of classifying the trusts that are said to arise and, indeed, if it is correct to say that such arrangements could give rise to any trusts at all. For instance, it is often a hard, if not impossible, task to locate sufficient evidence of any form of intention held by the relevant parties that would support the trusts and beneficial interests that are said to arise from the expression of some particular purpose for which the funds are to be used.⁶⁰⁷ If there are trusts then it may be questionable whether they are express or implied trusts, whether there is one trust or two trusts, if there is one trust, whether it has one or two limbs, whether in their primary form such trusts are for the benefit of identifiable beneficiaries or are for some purpose, how the interest arises under the secondary limb or trust, and the nature of the rights enjoyed by the potential beneficiaries under the two trusts or limbs, particularly in the period before it is certain if the primary trust or limb will be carried out.

14.12.3.1 Although Lord Wilberforce in the *Quistclose* case said that the primary trust that he described was in favour of the shareholders to whom the dividend was payable, the language that he used and some of the subsequent cases would appear to indicate that such a primary trust might be described as a type of purpose trust. Indeed, Sir Robert Megarry V-C in *In re Northern Developments (Holdings) Ltd*⁶⁰⁸ seems to have identified the arrangements in that case as giving rise to a purpose trust which was enforceable by identified individuals, even though the beneficial interests under either trust or limb might not have vested but were held in suspense pending the outcome of the arrangements.⁶⁰⁹ In *Re EVTR*⁶¹⁰ the Court of Appeal was willing to accept that there was a primary trust of the proceeds of a loan ‘for the purchase of equipment’. This is troubling because it is a fairly elementary principle of the law of trusts that, with very limited exceptions, it is not possible to have private purpose trusts.⁶¹¹

14.12.4 The questionable need for protection

It is questionable if lenders and other providers of funds really need the protection that the *Quistclose* case purports to give them. The *Quistclose* case is seen as furnishing a form of quasi-security as protection to an otherwise unsecured lender against the default of a borrower, where the lender has parted with its funds before they are needed for the requisite purpose. However, in devising unsecured loan facilities,

⁶⁰⁷ See, for instance, the difficulties that were encountered in *Re Goldcorp Exchange Ltd* [1995] 1 AC 74 and in *Re Farepak Food and Gifts Ltd* [2006] EWHC 3272 (Ch), [2007] 1 BCLC 1. The importance of ascertaining the structure of the arrangements and the contractual mechanisms involved was emphasised by Patten LJ in *Raymond Bieber v Teathers Limited (in liquidation)* [2012] EWCA Civ 1466, [2013] 1 BCLC 24, paras 13-15.

⁶⁰⁸ Unreported, 6/10/1978.

⁶⁰⁹ See also the discussion by Peter Gibson J in the *Carreras Rothmans* case [1985] Ch 207, at 222.

⁶¹⁰ [1987] BCLC 646.

⁶¹¹ See, however, Norris J in *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch) [20], [2012] 2 BCLC 585 saying that the trust is not a purpose trust but rather a resulting trust in favour of the payer with a mandate granted to the recipient to apply the money paid for the purpose state.

lenders and their lawyers are quite familiar with employing structures which ensure that the funds can only be drawn down at the time they are required for application for the purpose identified in the facility. If the borrower is unable to meet the stipulated requirements then the funds will not be provided and the lender will still have its money. A similar device could also be used in other forms of transaction. Furthermore, the law already provides protection for those lenders who wish to be protected from an insolvency of a borrower. The lenders could take security for repayment. That could have been done in the *Quistclose* case, where the lender could have taken security over the balance standing to the credit of the account at Barclays Bank, although it must be conceded that such security would probably only have been by way of floating charge. Following the decision of the House of Lords in *Re Bank of Credit and Commerce International SA (No 8)*,⁶¹² security could now also be taken by a bank lender where the proceeds of the loan had been credited to an account with the bank itself. It is also possible for the provider of the funds, including a provider who has provided the funds, otherwise than by way of loan, to gain protection before the funds have been used, by stipulating expressly for the funds from the outset to be impressed with a trust in its favour pending disbursement of the funds as the provider of the funds has approved.⁶¹³ A further possibility is that a recipient of funds can declare itself to be the trustee of them under an express trust.⁶¹⁴ Since the *Quistclose* type trust is not a security interest, there is no obligation to register it, and it is therefore invisible to other creditors of the trustee. This objection, of course, also applies to express trusts, but the rigorous requirements of intention for such trusts tends to limit their use in this way.

14.12.5 Sufficient intention or purpose

There is also a difficulty in ascertaining when the intention or purpose of the arrangement has been defined with sufficient precision so as to invoke the aid of the *Quistclose* case. Lord Wilberforce made it clear that there must be a 'specific purpose' underlying the intended use of the money. The difficulty which then arises is to understand the point at which an arrangement will be incapable of identification with sufficient precision for the *Quistclose* case to apply. In the *Quistclose* case the purpose was specific enough for the protection to follow. It must be questionable, however, if the purpose of using funds for the purchase of equipment in *Re EVTR* was sufficiently specific to deserve the favourable result given to the lender of the funds in that case. On the other hand, in *Re Challoner Club Ltd*⁶¹⁵ it was held that funds provided by the members of a club to its directors, to be used for the purpose of safeguarding its future, was too imprecise as a purpose to prevent the funds from falling into the hands of the club's liquidator.⁶¹⁶ It would also seem that a sufficiently clear purpose must be separate from a constitution of a trust. In a recent decision in *Du Preez Ltd (formerly Habana Ltd) v Kaupthing Singer & Friedlander (Isle of Man) Ltd*⁶¹⁷ the High Court of the Isle of Man refused to find a *Quistclose* trust of money already in the account for two reasons: first, although instructions as to the account

⁶¹² [1998] AC 214.

⁶¹³ See, for instance, the example given by Lord Millett of the solicitor in *Twinsectra Ltd v Yardley* [2002] UKHL 12, [2002] 2 AC 164, at [99].

⁶¹⁴ As was done in *Re Kayford Ltd* [1975] 1 WLR 279. See also *OT Computers Ltd v First National Tricity Finance Ltd* [2003] EWHC 1010 (Ch), at [14]–[16].

⁶¹⁵ The Times, 4/11/1997.

⁶¹⁶ See also *Re Holiday Promotions (Europe) Ltd* [1996] BCC 671.

⁶¹⁷ [2011] WTLR 559.

were routinely given, no new money was paid to the bank and secondly, there was no evidence that Kaupthing had expressly constituted itself as a trustee of the funds in issue.

14.12.6 Acceptance of the principle

Notwithstanding the various doubts that have arisen following the decision in the *Quistclose* case, it has to be admitted that a number of eminent judicial minds have accepted that trusts of the type described in the *Quistclose* case can exist, although there remains uncertainty as to the basis of the principles it established. Such a body of judges is headed by Lord Wilberforce, Lord Millett,⁶¹⁸ and Lord Browne-Wilkinson,⁶¹⁹ and also includes Sir Robert Megarry, Sir Christopher Slade,⁶²⁰ and Mr Justice Gummow in Australia.⁶²¹ There have been a number of attempts by academics to provide an analysis of the *Quistclose* case and the principles that flow from it.⁶²²

14.12.7 Judicial analysis of *Quistclose*

14.12.7.1 Lord Millett provided a useful analysis of the *Quistclose* case in *Twinsectra Ltd v Yardley*.⁶²³ Lord Millett said in the *Twinsectra* case that the beneficial interest in the funds should be considered, even if not expressed by the parties as such, as remaining from the outset in the lender or provider of the funds, so that the borrower or recipient is simply a trustee holding the funds for such a lender or provider of funds on a resulting trust, with a power or duty to disburse the funds in the circumstances contemplated by the arrangements agreed between them. On this basis, the third parties who were intended to receive the funds would not acquire any beneficial or other enforceable interest in them until such time as the funds had been disbursed to them. Lord Millett's analysis provides a much needed rationale for this area of the law, although it has to be said that it is at variance with the views expressed in some of the other cases mentioned above. A difficulty that arises in Lord Millett's analysis would concern the situation where the provider of the funds became insolvent and went into liquidation before the funds had been used for the agreed purpose. At that point, the authority of the borrower to disperse the funds would cease, despite the fact that the borrower had borrowed the funds and had contracted for the right to use them.

14.12.7.2 A useful summary of principles determining whether a *Quistclose* trust arises has recently been provided in *Bieber v Teathers Ltd (In liquidation)*.⁶²⁴ These are as follows.⁶²⁵

- (1) The parties must not intend that the money will be at the free disposal of the recipient.⁶²⁶

⁶¹⁸ See *Twinsectra Ltd v Yardley* [2002] UKHL 12, [2002] 2 AC 164.

⁶¹⁹ See *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, at 707–708.

⁶²⁰ See *R v Common Professional Examination Board, ex p Mealing-McCleod*, *The Times* 19/4/2000.

⁶²¹ See *Re Australian Elizabethan Theatre Trust* (1991) 102 ALR 681.

⁶²² See William Swadling (ed), *The Quistclose Trust: Critical Essays* (Hart, 2004).

⁶²³ [2002] UKHL 12; [2002] 2 AC 164, at [52]–[103].

⁶²⁴ [2012] EWHC 190 (Ch) paras 15–25 (Norris J).

⁶²⁵ References to authorities that accompany each point below are cited after Norris J in *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch) paras 15–25 (Norris J).

⁶²⁶ *Re Goldcorp Exchange* [1995] 1 AC 74; *Twinsectra Ltd v Yardley* [2002] AC 164 para 74; *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch), [2012] 2 BCLC 585 [16] (Norris J).

- (2) Payment for the recipient to use it in a particular way is not of itself enough; it could simply give rise to personal obligations.⁶²⁷
- (3) It must be clear that the mutual intention of payer and recipient is that the money should not become a part of the general assets of the recipient but should be used *exclusively* to effect particular identified payments⁶²⁸.
- (4) A trust arises as equity intervenes because it is unconscionable for the recipient to obtain money but disregard the terms on which he received it from a payer who had placed trust and confidence in the recipient to ensure the proper application of the money paid⁶²⁹
- (5) Such a trust is akin to a “retention of title” clause in that it does not entrench the payer's property rights more than necessary to enable the purpose to be achieved. The recipient is precluded from misapplying the money and has no beneficial interest in it.⁶³⁰
- (6) The subjective intentions of payer and recipient as to the creation of a trust are irrelevant; it is only necessary that the effect of the construction of the express terms of the parties’ arrangement or the circumstances is to create a trust.⁶³¹
- (7) The particular purpose must be specified in terms so as to enable a court to say whether a given application of the money falls within its terms.⁶³²

14.12.8 Money received when the recipient has stopped trading

A different line of authority, but one which might also be raised in conjunction with a *Quistclose* case argument, is based upon what was said in *Neste Oy v Lloyds Bank plc*.⁶³³ In that case shipowners routinely paid sums of money to PSL as shipping agents for it to discharge harbor dues and other liabilities. The last payment was received by PSL (credited to PSL's account with Lloyds) after a decision was made that it should cease trading. The shipowners' bank sought repayment, which Lloyds refused and proceeded to exercise their right of set-off as between the group accounts. This was objected to by the shipowners arguing that it was held on trust by PSL to be applied for the payment of the shipowners' creditors.. While no *Quistclose* trust was found, a constructive trust was imposed on the money with PSL as a constructive trustee because it would be “short of sharp practice for PSL to take any benefit from the payment, and it would have seemed contrary to any ordinary notion of fairness that the general body of creditors should profit from the accident of a payment made

⁶²⁷ *Twinssectra Ltd v Yardley* [2002] AC 164 para 73, *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch) para 17 (Norris J).

⁶²⁸ *Toovey v Milne* (1819) 2 B&A 683, *Barclays Bank v Quistclose Investments* [1970] AC 567, 580, *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch) [18] (Norris J).

⁶²⁹ *Twinssectra Ltd v Yardley* [2002] AC 164 [76], *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch), [2012] 2 BCLC 585 [19] (Norris J).

⁶³⁰ *Twinssectra Ltd v Yardley* [2002] AC 164 [81], [87], [92], [100], *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch), [2012] 2 BCLC 585 [20] (Norris J).

⁶³¹ *Twinssectra Ltd v Yardley* [2002] AC 164 [71], *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch), [2012] 2 BCLC 585 [21] (Norris J).

⁶³² *Twinssectra Ltd v Yardley* [2002] AC 164 [16], *Bieber v Teathers Ltd* [2012] EWHC 190 (Ch), [2012] 2 BCLC 585 [22] (Norris J).

⁶³³ [1983] 2 Lloyd’s Rep 658.

at a time when there was bound to be a total failure of consideration.⁶³⁴ The decision has been highly controversial. While it has been doubted⁶³⁵ there are also attempts to reconcile it with existing body of law. Recently, the Court of Appeal suggested that decision in *Neste Oy* turned on the gratuitous nature of payments made to PSL as they were made solely to enable it to pay the debts of the shipowners, not in satisfaction of any liability between the shipowner and PSL.⁶³⁶ In those circumstances, the use of payment to meet the claims in the PSL's insolvency would be a real windfall for its creditors.

14.13 Company Registration Requirements

14.13.1 Part 25 of the Companies Act 2006 (the 'Act') deals with the requirement for the registration of company charges, that is, security given by companies.⁶³⁷ It has been reformed by Companies Act 2006 (Amendment of Part 25) Regulations 2013, which replaced sections 860 – 892 with sections 859A – 859Q. These Regulations apply to charges created on or after 6th April 2013, the date on which they came into force. The reform was a result of the exercise of power granted in section 894 of the Act and because of this was limited to reforming aspects of registration of security granted by companies. As a result, the need for a wider reform and its shape continues to be the subject of a debate.⁶³⁸

14.13.1.1 One of the key aims of the reform was to make use of the technological advances and facilitate electronic registration. Another was to enable the same registration system to apply to charges created by companies registered in Scotland as to those registered in England and Wales or Northern Ireland. The rules governing registration of charges found in the new sections 859A – 859Q are now contained in Chapter A1 of Part 25, which replaced both chapter 1 and chapter 2, the latter of which contained the provisions for companies that are registered in Scotland and which has been repealed.⁶³⁹ Chapter 3 of Part 25 is still in force. It contains various powers for making secondary legislation. The discussion that follows will concentrate on the provisions of Chapter 1 of Part 25, with an additional reference to Chapter 3 of Part 25 at the end. It will also be necessary to refer to section 1052 of the Companies Act 2006, which contains a power to make provision about the registration of specified charges over property in the United Kingdom of a registered overseas company.

⁶³⁴ See Bingham J in [1983] 2 Lloyd's Rep 658, at 666.

⁶³⁵ See the discussion by Mann J in in *Re Farepak Food and Gifts Ltd (sub nom Dubey v HMRC)* [2006] EWHC 3272 (Ch); [2007] 2 BCLC 1, at [37]–[40].

⁶³⁶ *Re D&D Wines International Ltd (In Liquidation) (sub nom Angove Pty Ltd v Bailey)* [2014] EWCA Civ 215, [2015] 1 All ER (Comm) 36 [41] (Patten LJ).

⁶³⁷ It largely re-enacts the previous provisions of Part XII of the Companies Act 1985, which, in turn, replaced the corresponding provisions of s 95 et seq of the Companies Act 1948. The legislative history of these provisions goes back to s 14 of the Companies Act 1900, which was extended by s 10(1)(e) of the Companies Act 1907 and further extended by s 43(1) of the Companies Act 1928 and s 79 of the Companies Act 1929 to what was pretty much the same as the present legislation. The 1948 Act, which replaced the previous legislation was, in turn, replaced by the 1985 Act.

⁶³⁸ See Chap 17 and L Gullifer and M Raczynska, 'The English Law of Personal Property Security: Under-reformed?' in L Gullifer and O Akseli (eds) *Secured Transactions Law Reform: Principles, Policies and Practice* (Hart 2016 forthcoming).

⁶³⁹ The failure by a Scottish company to comply with the registration requirements would be a matter that was justiciable before the English courts: *Arthur D Little Ltd v Ableco Finance LLC* [2002] EWHC 701 (Ch), [2003] Ch 217. See also for example *Enviroco Ltd v Farstad Supply A/S* [2011] UKSC 16, [2011] 1 WLR 921.

14.13.1.2 Sections 859A to 859Q apply with appropriate modifications to limited liability partnerships under regulation 32 of the Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009/1804.⁶⁴⁰

14.13.2 Registrable charges

The new section **859A** of the Act provides that all charges created by companies are registrable unless specifically excluded. The scope of what is registrable is therefore wider than previously, when there was a closed list of registrable charges⁶⁴¹, which included some categories of fixed charge and all floating charges.⁶⁴²

14.13.2.1 Exemptions from registration in section 859A of the Act include rent security deposits, charges securing underwriting obligations of corporate members of Lloyds and charges exempted under other legislation, the most important of which are the security financial collateral arrangements that fall within the Financial Collateral Arrangements (No 2) Regulations 2003.⁶⁴³ While the wording of the Act is open to the interpretation that the registrar has power to register charges which are not registrable charges, the Act only stipulates which interests the registrar *must* register, without making it clear whether the registrar *may* or *must not* register anything else. If the Act were interpreted permissively, it would be possible (but not necessary) to register charges that are exempted, and this would prevent Companies House being left with making what is sometimes a very difficult decision whether a charge is registrable or not, for example, whether it constitutes a security financial collateral arrangement or not. Thus far, it seems that the Act has unfortunately been understood restrictively so as to exclude any registrability of non-registrable charges, thus placing more pressure on the Companies House than otherwise.⁶⁴⁴

14.13.2.2 For purposes of Part 25 of the Act, the term “charge” also includes a mortgage.⁶⁴⁵

14.13.3 The process of registration

As already mentioned, the most prominent change brought about by the 2013 reforms is the ability to register online as well as in paper format. Electronic registration of charges takes place via the Companies House WebFiling and it is necessary to apply for an authentication code in order to do so.⁶⁴⁶ The registrar must register the charge if the company or a person interested in the charge delivers to the registrar the statement of particulars within the period allowed for deliver.⁶⁴⁷ Where the charge is created or evidenced by an instrument, which is often the case, the registrar’s obligation does not arise unless a certified copy of that instrument is delivered with the statement

⁶⁴⁰ As amended by the Limited Liability Partnerships (Application of Companies Act 2006) (Amendment) Regulations 2013/618, Sch 1 para 1.

⁶⁴¹ Formerly s 860 of the Act.

⁶⁴² This means that it is no longer relevant to consider whether a charge is fixed or floating for the purposes of registration. The distinction is still relevant for other reasons, crucially in insolvency.

⁶⁴³ See above 14.7.6.

⁶⁴⁴ Anecdotal evidence (a telephone conversation with an employee at the Companies House) suggests that the practice of the Companies House is to refuse such registration when it decides that the charge falls within an exemption.

⁶⁴⁵ S 859(7).

⁶⁴⁶ The complexity of this process detracts from the usability of the online system in favour of using paper documentation.

⁶⁴⁷ S 859A of the Act.

particulars, which in the case of online registration is a pdf version of the document. The Act provides separately that the registrar has an obligation to register a charge when it is in a series of debentures⁶⁴⁸ and where the company acquired property subject to a charge.⁶⁴⁹

14.13.3.1 The period is, as was previously, 21 days beginning the day after the date of creation of the charge. Charges created outside the UK no longer benefit from an extended period. What constitutes the date of creation is now comprehensively defined⁶⁵⁰, which was thought to be a necessary clarification in light of the UK-wide registration.

14.13.3.2 The statement of particulars is delivered on one of the forms provided by the Companies House, which differ to some extent depending on whether the charge is created or evidenced by an instrument or not, whether the charge is in a series of debentures or whether the charge already existed on property acquired. There are also separate forms for LLPs. Where the charge is created or evidenced by an instrument, the statement of particulars must identify the chargor, the chargee and the date of creation of the charge and, it is necessary to describe the nature of the charge, the property charged and the obligations secured by the charge.⁶⁵¹ It is now also possible, which was not previously, to indicate in the statement of particulars one of the following matters by way of a ‘yes or no’ tickbox:

- a) Whether the charge instrument creates a fixed charge over any other property.
- b) Whether the charge instrument creates a floating charge and, if so, whether it is over all the property and undertaking of the company.
- c) Whether the terms of the charge⁶⁵² include a clause prohibiting or restricting the chargor from creating security which ranks equally with or ahead of the charge (a negative pledge clause).
- d) Whether the company is acting as trustee in relation to the charged property (it is optional to include this information).
- e) There is also a box to provide a short description of any land, ships, aircraft or intellectual property which are subject to a fixed charge in the charge instrument.

In cases where the charge is not created or evidenced by an instrument, it is necessary to describe the nature of the charge, the property charged and the obligations secured by the charge. There is an optional tickbox to indicate whether the company is acting as trustee in relation to the charged property.⁶⁵³ Further details must be included if the charge is in a series of debentures.⁶⁵⁴

14.13.3.3 When all the documents, which are required to be delivered, are received, the registrar issues a unique charge identification code⁶⁵⁵, which links the particulars with the instrument on the register. Thus, both are available to be viewed on the register. The registrar must issue a certificate to the person who made the

⁶⁴⁸ S 859B of the Act.

⁶⁴⁹ S 859C of the Act.

⁶⁵⁰ S 859E of the Act.

⁶⁵¹ Section 859D of the Act, formerly section 869 of the Act.

⁶⁵² And not, for example, the loan agreement. See further L Gullifer and M Raczynska, ‘The English Law of Personal Property Security: Under-reformed?’ in L Gullifer and O Akseli *Secured Transactions Law Reform: Principles, Policies and Practice* (Hart 2016 forthcoming).

⁶⁵³ See s 859J of the Act.

⁶⁵⁴ S 859B of the Act.

⁶⁵⁵ S 859I(2) of the Act.

delivery⁶⁵⁶, identifying the company who granted the charge and the unique reference code allocated to the charge⁶⁵⁷. Given that the registrar no longer checks the particulars against the charge document, the certificate cannot serve as conclusive evidence that any of the particulars registered are correct. It is only conclusive evidence only as to the fact that the charge is not invalid as a result of late delivery (or, if late, that the court granted leave for it).

14.13.3.4 The register held by Companies House is searchable online, as was previously, via WebCheck and CompaniesHouseDirect. A person searching the register cannot rely on the registered particulars or the certificate and should check the entire charge document.

14.13.3.5 A company is no longer required to keep a separate register of charges but it must keep available for inspection copies of the full instrument, if any, as well as a copy of other documents containing charge particulars or particulars relating to the property.⁶⁵⁸ The Act provides the manner in which copies of these documents are to be kept by the company.

14.13.3.6 For convenience, the process of delivering the charge and the prescribed particulars to the registrar is referred to below as ‘registering’ the charge, although the statutory language refers to making the delivery.

14.13.4 The consequences of a failure to register

Pursuant to section 859H of the Act the consequence of failure to register within the prescribed period is invalidity of the charge against ‘creditors’, liquidator or administrator. The money secured by a charge which becomes invalid under this section becomes immediately payable.⁶⁵⁹ This civil sanction is the same as under the previous law,⁶⁶⁰ and its purpose is to provide an incentive to the obligor to grant a new charge to the secured party, rather than the secured party having to applying for leave to register the charge late.⁶⁶¹ By contrast, the criminal sanction of a fine for failure to register imposed on the company or officers in default⁶⁶², which has attracted much criticism, has now been abolished in the 2013 reforms. This means that registration is no longer mandatory in the sense that there is no obligation to deliver the charge to the registrar. A company or a person interested in the charge is free to decide not to deliver although will need to face the consequences of lack of registration when the issue of validity arises against the creditors or insolvency officers, and also the consequences of the secured debt becoming immediately payable.⁶⁶³

14.13.4.1 As previously, a ‘creditor’ for the purposes of the section, that is, a creditor against whom the unregistered charge is void, means a creditor with a

⁶⁵⁶ S 859Q of the Act.

⁶⁵⁷ S 859I(3) and (4) of the Act, previously section 869(6)(b) of the Act.

⁶⁵⁸ S 859P of the Act. This could be relevant, for example, where a negative pledge clause is included in the terms of the loan agreement and not the charge instrument.

⁶⁵⁹ S 859H of the Act.

⁶⁶⁰ Formerly s 874 of the Act.

⁶⁶¹ See 14.13.6.

⁶⁶² Formerly ss 860 (4) and (5) of the Act.

⁶⁶³ For example, these consequences could be commercially severe even if the charge is rescued from invalidity on insolvency by other legislation, such as a charge over an aircraft which is registered in the International Registry under Regulation 14 of the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015.

proprietary interest in the charged assets, namely, a secured creditor or an execution creditor.⁶⁶⁴ This is because unsecured creditors have no proprietary entitlement in the assets before the onset of an insolvency of the chargor, and their interests are represented by the liquidator or administrator in the liquidation or administration of the chargor.

14.13.4.2 In *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend CBC*⁶⁶⁵ the House of Lords considered what was meant when the (predecessor) section said that the unregistered charge was void as against a liquidator or administrator of the company. The wording meant that the charge was void as against the company in liquidation or administration, as represented by that person. The intention was to protect the interests of the company, so that the charged assets would be available to the company and its creditors as if the charge did not exist. One result of this was that the liquidator or administrator was entitled to pursue the invalidity on behalf of company, including the right of the company to bring an action for conversion against the chargee which had wrongly enforced the void security and disposed of the charged assets.

14.13.4.3 Where the charged property consists of debts that have been assigned to the chargee under an unregistered charge, and the chargor goes into liquidation or administration, the chargee is not entitled to receive the debts because they are treated as being the unencumbered property of the chargor. This also has the effect, as it had under previous law, that the chargee cannot demand payment of the debts and the debtor is entitled to rely on the section to refuse to pay the chargee and, instead, to account to the chargor.⁶⁶⁶ Otherwise, the debtor would be at risk of being in double jeopardy in being obliged to pay both the liquidator or administrator of the chargor, as well as the chargee.

14.13.4.4 It should be noted that a purchaser of charged assets is not entitled to rely on the section to assert the invalidity of the security.⁶⁶⁷ That deficiency would have been cured by the amendments to the companies charges registration regime that were contemplated by the Companies Act 1989.⁶⁶⁸ Although this was noted, and a relevant proposal was made in the period leading up to the 2013 reform⁶⁶⁹, no change was unfortunately introduced.

⁶⁶⁴ See Lord Brightman, sitting in the Court of Appeal, in *Re Ashpurton Estates Ltd* [1983] Ch 110, at 119, relying upon the earlier decision of the Court of Appeal in *Re Ehrmann Brothers Ltd* [1906] 2 Ch 697.

⁶⁶⁵ [2001] UKHL 58, [2002] 1 AC 336.

⁶⁶⁶ *Orion Finance Ltd v Crown Financial Management Ltd* [1996] BCC 621, at 631–635.

⁶⁶⁷ A point that was overlooked in *E Pfeiffer Weinkellerei-Weineinkauf GmbH v Arbuthnot Factors Ltd* [1988] 1 WLR 150.

⁶⁶⁸ See s 399(1)(a) of the Companies Act 1985, as inserted by s 95 of the Companies Act 1989 (never in force).

⁶⁶⁹ See Department for Business Innovation and Skills (BIS), *Government Response—Consultation on Registration of Charges created by Companies and Limited Liability Partnerships* (BIS, December 2010) proposal F and see BIS, *Revised Scheme for Registration of Charges created by Companies and Limited Liability Partnerships: proposed revision on Part 25, Companies Act 2006* (BIS, August 2011, URN 11/1108) para 37 (stating that the discussion with the stakeholders resulted in the rejection of the proposal).

14.13.5 Other entries on the register

14.13.5.1 Section 859K of the Act⁶⁷⁰ provides that if a receiver of a company's property is appointed, either by the court or under a security instrument, the person who obtained the court appointment, or who appointed the receiver under the security, must notify the registrar of the appointment within seven days after the appointment and provide the unique reference code allocated to the charge (in relation to charges created on or after 6th April 2013). Upon relinquishing his appointment, if appointed under a security instrument, the receiver must notify the Registrar of that fact. It is an offence if those requirements are not met. In both cases (of taking up and cessation of appointment) the registrar must include the fact of which it was notified in the register. This section therefore preserves the previous law. It only applies to receivers appointed under the law of English and Wales or Northern Ireland.⁶⁷¹

14.13.5.2 Section 859L of the Act⁶⁷² provides for the registrar to enter on the register a note of the satisfaction, in whole or in part, of the amount secured by, or the assets comprised within, a registered charge. This is triggered by the delivery to the registrar of a statement along with the particulars of the person delivering it along with the particulars of company and the charge. It is not required that a deed of discharge is delivered to the registrar, nor will the registrar record the absence of such evidence. This may open door to abuse of this section, even fraudulent filing, for which the only sanction is the sanction for false statements made to the registrar under section 1112 of the Act.

14.13.5.3 Under section 859O of the Act it is possible to register an amendment or the addition of certain types of terms to the charge after its creation. This applies to terms of the charge adding or amending a negative pledge clause and a variation of priorities agreement.

14.13.5.4 Following a relevant court order delivered to the registrar, the registrar includes an entry of rectification of any statement or notice, which were delivered to him, and removes the copy of the instrument, replacing it with a new one. Sections 859M and 859N of the Act provide, respectively, the grounds on which the court issues such orders.

14.13.6 Late registration

Where the documents required for delivery to register a charge have not been delivered within the prescribed period, the court may grant the permission for the late registration of a charge under section 859F of the Act. The period for delivery may be extended by the court⁶⁷³ on the same grounds as before⁶⁷⁴, namely where the failure to deliver was accidental or is not of a nature to prejudice creditors or shareholders or a relief is just and equitable.⁶⁷⁵ Given the similarity to how this was

⁶⁷⁰ Formerly s 871 of the Act.

⁶⁷¹ Ss 859K(8) and (9) of the Act.

⁶⁷² Formerly s 872 of the Act.

⁶⁷³ S 859F of the Act.

⁶⁷⁴ Formerly s 873 of the Act.

⁶⁷⁵ The permission would likely be refused where there had been a deliberate decision by the chargee not to register when it knew that the charge should be registered because it would not be a result of accident or inadvertence, see: *Barclays Bank PLC v Stuart Landon Ltd* [2001] EWCA Civ 140; [2002] BCC 917, 621 (Chadwick LJ) (while the decision was made on the basis of section 404 of the Companies Act 1985, the current law mirrors the grounds that were contained in that section).

framed prior to the 2013 reform, the case law that developed under previous law remains relevant.

14.13.6.1 The court's power of discretion to permit late registration, albeit wide⁶⁷⁶, has some limits. In the first place, the court is not likely to look favourably on an application where there has been knowing delay in seeking relief after the failure to register has been discovered.⁶⁷⁷ Secondly, the court is likely to refuse to permit registration where proceedings for winding up have been commenced when the application is made for permission.⁶⁷⁸ Where winding-up proceedings were imminent at the time of the application, but had not yet been commenced, that fact was a relevant factor for the court to consider but the court should still be prepared to grant permission unless it was certain that a later application to have the permission set aside (as shortly to be referred to) was bound to succeed.⁶⁷⁹

14.13.6.2 If the court grants permission for late registration, it will normally provide in its order that the late registration is to be without prejudice to the interests of third parties that have been acquired in the charged assets prior to the date that late registration takes place.⁶⁸⁰ However, if a third party took its interest on the basis that its rights would be postponed behind those of the unregistered charge, then an exception is likely to be made to make it clear that the rights of such a person will remain postponed behind the charge.⁶⁸¹ Similarly, if a person who is responsible for the failure to register the charge has itself obtained an interest in the charged property, that person's interest should be under current law, as was the case previously, postponed behind the charge.⁶⁸²

14.13.6.3 The court order may issue the order on such terms and conditions as seem just and expedient to the court.⁶⁸³ For example, if permission is given at a time when winding-up proceedings are imminent, then the court is likely to require that its order may be challenged by an unsecured creditor or the liquidator if liquidation of the chargor occurs within a set period after the late registration is achieved.⁶⁸⁴ The point of this is to permit such a creditor to show that it gave credit to the company, having searched, believing that its property was unencumbered. It also permits the liquidator to challenge the order on the basis that there were no proper grounds for permitting late registration, such as because the liquidator can establish that there had been a deliberate decision not to register the charge in the first place.⁶⁸⁵

⁶⁷⁶ *Re Braemar Investments Ltd* [1989] Ch 54.

⁶⁷⁷ *Re Ashpurton Estates Ltd* [1983] Ch 110. On this point, it might be argued that the court was unduly sympathetic in *Re Fablehill Ltd* [1991] BCC 590.

⁶⁷⁸ *Re Ashpurton Estates Ltd* [1983] Ch 110. In that case, the court also refused permission where the insolvency proceedings had been commenced whilst an appeal against a refusal to grant permission was pending. As to the position where an administrator had been appointed, see Millett J in *Re Barrow Borough Transport Ltd* [1990] Ch 227.

⁶⁷⁹ *Re Ashpurton Estates Ltd* [1983] Ch 110; *Re Braemar Investments Ltd* [1989] Ch 54; *Barclays Bank PLC v Stuart Landon Ltd* [2001] EWCA Civ 140, [2002] BCC 917.

⁶⁸⁰ See *Re Ashpurton Estates Ltd* [1983] Ch 110, at 122–124. Section 859F(2) of the Act explicitly refers to the failure to deliver the documents being not of a nature to prejudice the position of creditors or shareholders of the company.

⁶⁸¹ *Barclays Bank PLC v Stuart Landon Ltd* [2001] EWCA Civ 140, [2002] BCC 917.

⁶⁸² *Re Fablehill Ltd* [1991] BCC 590.

⁶⁸³ Section 859F(3) of the Act.

⁶⁸⁴ This is the so-called 'Re Charles' order: *Re Charles (LH) & Co Ltd* [1935] WN 15.

⁶⁸⁵ *Barclays Bank PLC v Stuart Landon Ltd* [2001] EWCA Civ 140, [2002] BCC 917.

14.13.7 The power to make secondary legislation

Chapter 3 of Part 25 of the Companies Act 2006, comprising sections 893 and 894 of the Act, contains provisions to permit secondary legislation to be made dealing with the effect of a registration in another register and the ability to make amendments to Part 25. Another power to make secondary registration is contained in section 1052 of the Act and concerns registration of charges over property of a registered overseas company.

14.13.7.1 Under section 893 of the Act, secondary legislation may be made as to the sharing of information between the Companies Registry and other registries, including foreign registries, the consequence of which could be that charges that are registered in such other registries need not be registered separately in the Companies Registry. In such instances, there would be a cross-reference made in the Companies Registry to the registration in the other registry. Examples of where this might occur would be registration of a legal charge in the Land Registry or of security in the specialist registries dealing with ships, aircraft, or intellectual property. The power in section 893 has not yet been exercised.

14.13.7.2 Power under sections 894 was exercised⁶⁸⁶, as discussed above. The issues concerning section 1052 of the Act are discussed in the part that follows.

14.13.8 Security given by a registered overseas company

The state of law on registration of security granted by foreign companies has been rather unstable. The rules provided under the Companies Act 1985 were unsatisfactory, as explained below. The 2006 Act gave a power under section 1052 to make secondary legislation for registration of a charge over property in the UK granted by an overseas company if the company was registered in the UK.⁶⁸⁷ The presence of the power was generally a welcome change from the position that had applied previously despite the limitation that the company be registered in the UK. The power was exercised in by making the Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009.⁶⁸⁸ The Regulations came into force on 1 October 2009 but the relevant part of these Regulations governing registration of charges by foreign companies (Part 3) was revoked with effect from 1 October 2011.⁶⁸⁹ These Regulations continue to impose various duties in relation to charges, which are discussed after addressing the key historical developments of this area of law.

14.13.8.1 Under section 409 of the Companies Act 1985, if a company that was incorporated outside Great Britain, which had established a place of business in England and Wales, gave a charge of a registrable category over property in England and Wales (or acquired property subject to such a charge), the charge had to be registered as if it had been given by an English company. The section applied whether or not the company had registered as an 'overseas company' under Part XXIII of the 1985 Act and it applied with respect to property which was in England and Wales

⁶⁸⁶ Companies Act 2006 (Amendment of Part 25) Regulations 2013/600.

⁶⁸⁷ That is, a company that has registered particulars under s 1046(1) of the Act.

⁶⁸⁸ SI 2009/1917.

⁶⁸⁹ Overseas Companies (Execution of Documents and Registration of Charges) (Amendment) Regulations 2011/2194, reg 2(3).

when the charge was created, or which came within that jurisdiction subsequently.⁶⁹⁰ The establishment of a place of business in England and Wales was a question of fact to be assessed as at the time the charge was created and implied a place of establishment of some permanence,⁶⁹¹ which it might be difficult to ascertain.

14.13.8.2 Because of the difficulties in knowing if the charge had to be registered, the practice had developed, in cases where the chargor was a foreign company and there was a possibility of the charged assets being or coming within the jurisdiction, of sending the charge to the Companies Registry, together with an attempt at supplying the relevant prescribed particulars, in the hope that this would satisfy the requirements of section 409 (commonly referred to as a ‘Slavenburg registration’). The ‘Slavenburg register’ had a limited functionality as there was no facility to submit enquiries to search it.

14.13.8.3 The Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009 introduced registration of charges granted by overseas companies in its Part 3. When they were in force the regulations applied to registration of charges granted by an overseas company that had a registered establishment in the UK and to property that was situated in the UK at the time the charge was created.⁶⁹² This did not extend to charges over property brought into the UK after the charge was created. Only certain categories of charge were registrable⁶⁹³, which corresponded to the law governing registration of charges granted by domestic companies under the former section 860 of the Companies Act 2006. The sanction for lack of registration was limited to civil consequences (invalidity against a liquidator, an administrator and a creditor of the company).⁶⁹⁴ This contrasted with the law governing at that time the granting of charges by domestic companies in relation to which the criminal sanction applied.

14.13.8.4 While the provision governing registration of charges granted by overseas companies have now been revoked,⁶⁹⁵ so that charges granted by overseas companies are no longer registrable in the Company Charges register, certain other provisions of the Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009 continue to apply. First, a registered overseas company⁶⁹⁶ has a duty to keep for inspection copies of every instrument creating a charge. This applies to charges on land or interest in land situated in the UK; charges on ships, aircraft⁶⁹⁷ or intellectual property registered in the UK and any floating charge on the

⁶⁹⁰ *Slavenburg’s Bank NV v Intercontinental Natural Resources Ltd* [1980] 1 WLR 1076 (the case was decided on the basis of section 95 of the Companies Act 1948, which was later replaced by section 395 of the Companies Act 1985).

⁶⁹¹ *Re Oriol Ltd* [1986] 1 WLR 180.

⁶⁹² Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 9(1) (now revoked).

⁶⁹³ Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 9(3)-(6) (now revoked).

⁶⁹⁴ Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 19 (now revoked).

⁶⁹⁵ By the Overseas Companies (Execution of Documents and Registration of Charges) (Amendment)

Regulations 2011, SI 2011/2194

⁶⁹⁶ As defined in the Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 8.

⁶⁹⁷ This requirement applies even to a charge over an aircraft which is an international interest under the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015.

whole or part of the company's property or undertaking situated in the UK⁶⁹⁸ unless the floating charge exclude all the property of the company situated in the UK or it purports to be a fixed charge.⁶⁹⁹ Failure to comply with this duty knowingly or willfully is met with a criminal sanction.⁷⁰⁰ The company must notify the registrar of the place, which must be at a location in the UK at which the company carries on business, at which the documents and the register are kept for inspection and of any change in that place.⁷⁰¹ A criminal sanction is imposed on the company and every office of the company for lack of compliance.⁷⁰² There is also a provision for inspection by electronic means.⁷⁰³

14.13.9 Re-characterisation

One consideration of relevance in relation to registration of charges is re-characterisation, which is understood as the process by which a transaction that has the superficial appearance of being in one form is treated, as a matter of law, as being of a different type. In the context of financing and similar transactions, the issue that arises is whether a transaction by which a financier or other type of creditor obtains a proprietary interest in an asset in the form of what appears to be outright ownership of the asset is nonetheless treated as having provided credit on the basis of only having security over the asset, so that its apparent outright proprietary interest is held as security, to which the recipient of the credit has an equity of redemption. The issue is pertinent in English law because of the traditional tolerance that the courts have shown in addressing the matter, although there appears in more recent times to have been a change in judicial approach.⁷⁰⁴ This subject is discussed in more detail in Chapter 12, as well as in Chapter 15, and the reader is referred to the discussion in those places for further reference.⁷⁰⁵

14.13.9.1 If a proprietary transaction is re-characterised as being, in reality, a form of security, then it would be necessary to consider if it amounts to a registrable

⁶⁹⁸ Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 24.

⁶⁹⁹ Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 24(2A).

⁷⁰⁰ Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 24(3)-(4).

⁷⁰¹ See the Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 25(1)-(4).

⁷⁰² Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 25(5)-(6).

⁷⁰³ Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009, reg 26A.

⁷⁰⁴ Two decisions in the Court of Appeal and two in the House of Lords serve to illustrate the change in judicial attitudes. The high water mark of a tolerant and laissez-faire approach is illustrated by the decision of the Court of Appeal in *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148. The tide was on the turn only a few years later in the decision of the Court of Appeal in *Orion Finance Ltd v Crown Financial Management Ltd* [1996] BCC 621, particularly in the discussion of Millett LJ, at 626–627. His Lordship was much more definite in delivering the advice of the Privy Council in *Agnew v Inland Revenue Commissioner* [2001] UKPC 28, [2001] AC 710. The approach that he took there was approved by the House of Lords in *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend CBC* [2001] UKHL 58, [2002] AC 336 and in *National Westminster Bank PLC v Spectrum Plus Ltd* [2005] UKHL 41, [2005] 2 AC 680.

⁷⁰⁵ See also the Australian case of *Beaconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* [2008] FCA 594, which concerned the effectiveness and characterisation of title transfer provisions in securities lending transactions. The court held that they did not amount to secured transactions.

charge under section 859A of the Act. If not registered the consequences will be as mentioned above.

14.14 Priorities

14.14.1 In English law it is possible for several people to claim proprietary interests in the same asset, whether by way of ownership or security. This arises from the fact that legal and equitable interests may exist in an asset, that there may be more than one equitable interest subsisting at the same time, and that transactions may take place at law or in equity.⁷⁰⁶ Accordingly, it is possible that different types of interest may exist in the same asset, which may or may not naturally be in harmony (e.g. legal v equitable, equitable v equitable, security v security, purchaser v security, and purchaser v purchaser). The parties may have agreed as to the order in which their respective interests will rank under a priority agreement and such an agreement will normally bind them to what they have agreed.⁷⁰⁷ In other situations, however, there may be a need to resolve the disharmony between the competing interests, which English law achieves through its priority rules. The rules are complex, piecemeal in nature and tend to depend upon a mixture of some general rules and the nature of the particular asset concerned. One general preliminary point that can be made is that the concept of notice (including constructive notice) is an important part of the rules. Another is that the date of registration of charges in the Companies House does not play a determinative or even a principal role in establishing priority⁷⁰⁸, a position which is in stark contrast with the simpler and more transparent priority rules found in numerous other jurisdictions, where priority is typically determined by date of registration, for instance under Article 9 of the Uniform Commercial Code, Personal Property Security Acts in Canada, New Zealand, Australia, Jersey, Malawi, Qatar⁷⁰⁹ or secured transactions laws in, for example, Bulgaria⁷¹⁰, Ghana⁷¹¹, Liberia⁷¹², Sierra Leone⁷¹³, Ireland⁷¹⁴, Poland⁷¹⁵, Romania⁷¹⁶, Serbia⁷¹⁷, Colombia⁷¹⁸ and Mexico.⁷¹⁹

⁷⁰⁶ Note, however, that if there is only one person with an interest in an asset, that interest can only be the full comprehensive legal title, as it is not possible to have a separate legal and equitable title vested in one person if there is no other person with an interest in the asset: see Viscount Radcliffe in *Commissioner of Stamp Duties (Qld) v Livingstone* [1965] AC 694, at 712; Slade J in *Re Bond Worth Ltd* [1980] Ch 228 and Lord Browne-Wilkinson in *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, at 706.

⁷⁰⁷ *Cheah Theam Swee v Equiticorp Finance Group Ltd* [1992] AC 472. See also s 94(1)(a) of the Law of Property Act 1925. See section 14.15

⁷⁰⁸ Registration under section 859A of the Companies Act 2006 constitutes notice to all those who could reasonably be expected to search the register although it is not clear who counts as such a person (a creditor seeking to take registrable security is likely to be one but the position is less clear in relation to e.g. a creditor a security which is not registrable). Another area of difficulty is of what is registration notice. This is unclear but it is likely that notice is in relation to both the registered charge instrument and the registered particulars and it seems that in the case where the two are inconsistent, the former prevails, see further L Gullifer and M Raczynska, 'The English Law of Personal Property Security: Under-reformed?' in L Gullifer and O Akseli *Secured Transactions Law Reform: Principles, Policies and Practice* (Hart 2016 forthcoming).

⁷⁰⁹ The Qatar Financial Center Security Regulations are based on Personal Property Security Acts.

⁷¹⁰ Bulgarian Law on Registered Pledges 1997.

⁷¹¹ Ghanaian Borrowers and Lenders Act 2008.

⁷¹² As part of Liberian Commercial Code (2010).

⁷¹³ Sierra Leone Borrowers and Lenders Act 2014.

⁷¹⁴ The Irish Companies Act 2014.

⁷¹⁵ The Polish Act on Registered Pledge and Register of Pledges in 1996.

⁷¹⁶ Romanian Civil Code 2011.

14.14.1.1 The rules are generally more straightforward if there is a specialist registration system for the particular type of asset involved than where such registration does not exist. This is the case with land, ships,⁷²⁰ aircraft,⁷²¹ and some types of intellectual property.⁷²² In general, priorities are determined by date of registration or notification of an interest on the register. In some instances, that might be defeated by an equity that has priority, as, for instance, one of which a party has notice. The rules governing priority become very complex and uncertain in relation to security granted by a company and registrable in the Companies House as well as in a specialist register. In addition, if none of the competing interests have been properly registered or notified then it will be necessary to fall back on the general principles. What follows will concentrate on the position for the general body of assets where no specialist register exists.

14.14.1.2 It should be noted that each of the rules that follow is subject to the special rules that apply in the case of further advances, which are discussed below.

14.14.2 Some general principles

There are some general principles, or themes, which appear when looking at the priority rules, which will now be described, although it must be borne in mind that they may be overtaken by specific rules that apply to particular types of assets.

14.14.2.1 The role of notice

The most important of the general principles concerns the effect upon a party if it has notice, including constructive notice (such as in consequence of registration of security at Companies House), of an interest in the same asset that is earlier in time to its own interest. Generally speaking, such notice will serve to defer the interest of the later party behind that of the earlier interest. This matter is discussed in Chapter 12, to which the reader is referred for further guidance.

14.14.2.2 Purchaser for value of the legal estate

Where a person (or a trustee acting on his behalf) acquires the legal estate in an asset and does so for value and without having notice (including by virtue of constructive

⁷¹⁷ The Serbian Law on Registered Security Interests in Movables 2003 (priority determined by date of registration following the 2011 reforms).

⁷¹⁸ Law no 1676.

⁷¹⁹ The Mexican registry of security interests was launched in 2010.

⁷²⁰ For mortgages in statutory form, priority is regulated by date of registration in the British Ship Register: para 8 of Sched 1 to the Merchant Shipping Act 1995. This is subject to the earlier filing of a priority notice under that para. Notice of an earlier unregistered mortgage will not defeat the statutory priority: *Black v Williams* [1895] 1 Ch 408.

⁷²¹ Priority of mortgages is by date of registration at the Aircraft Registry: Art 14 of the Mortgaging of Aircraft Order 1972 (SI 1972/1268). This is subject to the earlier filing of a priority notice under that article. Notice of an earlier unregistered mortgage will not defeat the statutory priority: Art 14(4). Those taking a security interest in an aircraft may now register it in the International Registry, and obtain priority over all other interests in the aircraft except any prior interest registered in the International Registry, see International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015 Regulation 16.

⁷²² I.e. trade marks, patents, and registered designs, as previously described. Note, however, the complexity of the priority rules in relation to patents and trade marks, see 14.8.

notice) of an earlier equitable interest in the asset,⁷²³ the legal estate will prevail over the equitable interest.⁷²⁴ This does not apply, however, in relation to debts and similar choses in action.⁷²⁵ It would appear that the relevant time for determining if a party had notice of an earlier interest is at least the time when the purchaser gave value. The position is not entirely clear if the purchaser (i.e. an outright purchaser or a mortgagee) acquires notice of an existing equitable interest in the interval between giving value and then acquiring the legal title. It would appear that if the earlier equitable interest exists otherwise than under a trust, the purchaser (provided that it is not a mortgagee) can rely upon the doctrine of *tabula in naufragio* and take free of the equitable interest.⁷²⁶ However, if the earlier equitable interest is that of a beneficiary under a trust, the conveyance of the legal title will involve a breach of trust upon which the purchaser cannot rely.⁷²⁷

14.14.2.2.1 To that qualification there is a separate further exception in relation to the acquisition of a legal estate in shares, through becoming registered as the shareholder. If the purchaser both provided its consideration and acquired the share certificate and a valid transfer form duly executed by the existing registered holder without having notice of an existing beneficial interest in the shares, the purchaser will prevail over the earlier beneficial interest (howsoever it exists), even if the purchaser acquired notice in the intervening period before it became registered as the holder of the shares.⁷²⁸ Purchases of dematerialized shares registered in the CREST register will normally take free of any previous equitable interests by the operation of the CREST rules.⁷²⁹

14.14.2.2.2 It would also appear to be the case that a purchaser who acquired a good legal title having done so for value and without notice of an existing beneficial interest can pass on that title to a sub-purchaser that does have notice of the beneficial interest, provided the sub-purchaser is not involved in a fraud or has otherwise participated in a breach of trust involving the original transfer to the first purchaser.⁷³⁰

14.14.2.3 *The nemo dat rule*

The other side of the coin to the rule favouring a bona fide purchaser of the legal estate, is the rule encapsulated in the Latin maxim, '*nemo dat quod non habet*', namely, that a person cannot confer a better estate than he possesses. Accordingly, a person without a legal estate cannot confer such an estate on someone else. There are certain exceptions to the rule. The most important relate to goods and the exceptions contained in the Sale of Goods Act 1979, the Factors Act 1889, and Part III of the Hire Purchase Act 1964. More generally, there is an exception where a person is

⁷²³ If the purchaser is using a trustee to acquire for him then both the purchaser and the trustee must be without notice.

⁷²⁴ See *Pilcher v Rawlins* (1872) LR 7 Ch App 259; *Macmillan Inc v Bishopsgate Investment Trust (No 3)* [1995] 1 WLR 978, 1000 (the case was subject to an appeal that did not deal with this issue: [1996] 1 WLR 387).

⁷²⁵ See Phillips J in *E Pfeiffer Weinkellerei-Weineinkauf GmbH v Arbuthnot Factors Ltd* [1988] 1 WLR 150, 161

⁷²⁶ *Macmillan Inc v Bishopsgate Investment Trust (No 3)* [1995] 1 WLR 978, 1002–1003.

⁷²⁷ *Harpham v Shacklock* (1881) 19 ChD 207; *Macmillan Inc v Bishopsgate Investment Trust (No 3)* [1995] 1 WLR 978, 1003–1004.

⁷²⁸ *Dodds v Hills* (1865) 2 H&M 424; *Macmillan Inc v Bishopsgate Investment Trust (No 3)* [1995] 1 WLR 978, 1003–1004.

⁷²⁹ Uncertificated Securities Regulations 2001 reg 35(4) and CREST Rule 7 3.2

⁷³⁰ *Wilkes v Spooner* [1911] 2 KB 473.

conferred with actual or apparent authority by the true owner to deal with the owner's title.

14.14.2.4 *Competing equitable interests*

In a competition as between equitable interests, the starting point is the general rule that where the equities are equal, the first in time should prevail.⁷³¹

14.14.2.4.1 Under the doctrine of *tabula in naufragio*, the holder for value of a later equitable interest in tangible property⁷³² which gets in the legal estate can overreach an earlier equitable interest, provided it did not have notice of the earlier equitable interest when it gave value for the acquisition of its own equitable interest.⁷³³ For the reasons already stated, this does not apply if the earlier equitable interest was that of a beneficiary under a trust and the holder of the later interest knew of it at the time it acquired the legal estate. Nor does it apply in favour of a mortgagee, because of section 94(3) of the Law of Property Act 1925.⁷³⁴

14.14.2.4.2 There is a series of cases where the holder of a prior equitable interest in tangible property has been held to have lost its priority to the holder of a subsequent equitable interest because the merits of the holder of the subsequent interest were greater than those of the earlier interest.⁷³⁵ Some of the cases are based on a concept of 'negligence' or 'postponing conduct' on the part of the earlier holder, the consequence of which is that the subsequent holder was misled into believing that the earlier interest did not exist, as, for instance, where title deeds were left available to a mortgagor so that it could represent that the property was unencumbered,⁷³⁶ where the prior holder has postponed its interest by waiver,⁷³⁷ or where the prior holder was a mere volunteer and the subsequent holder gave value and had no notice of the earlier interest.⁷³⁸

14.14.2.5 *The purchase money security interest*

The concept of 'purchase money security' refers to an interest that protects the position of someone who advances money for the purchase of an asset on the basis of an agreement, on which the advance is made, that it will be given fixed security by the borrower over that asset to secure the advance. The interest of the holder of the security is a 'purchase money security interest'. Under English law the concept is generally thought to be limited to a situation where the holder of such security enjoys priority over an earlier *general* security interest which would catch the relevant asset

⁷³¹ See Phillips J in *E Pfeiffer Weinkellerei-Weineinkauf GmbH v Arbuthnot Factors Ltd* [1988] 1 WLR 150, 161–163

⁷³² This rule does not apply to choses in action, because the rules for choses are entirely derived from the equitable rules as to competitions between equitable interests, for the reasons explained by Phillips J in *E Pfeiffer Weinkellerei-Weineinkauf GmbH v Arbuthnot Factors Ltd* [1988] 1 WLR 150, 161.

⁷³³ *Bailey v Barnes* [1894] 1 Ch 25; *McCarthy & Stone Ltd v Julian S Hodge & Co. Ltd* [1971] 1 WLR 1547, 1555–1556.

⁷³⁴ See *McCarthy & Stone Ltd v Julian S Hodge & Co Ltd* [1971] 1 WLR 1547, at 1,556; *Macmillan Inc v Bishopsgate Investment Trust (No 3)* [1995] 1 WLR 978, 1002.

⁷³⁵ The cases are discussed by Meagher, Gummow and Lehane, *Equity: Doctrines and Remedies* (5th edn, 2015), paras 8-030 to 8-080.

⁷³⁶ *Farrand v Yorkshire Banking Co* (1888) 40 ChD 182; *Walker v Linom* [1907] 2 Ch 104.

⁷³⁷ *Fung v Tong* [1918] AC 403.

⁷³⁸ *Taylor v London and County Banking Co* [1901] 2 Ch 231.

by way of an after-acquired property clause.⁷³⁹ This will be the result even if the purchase money security holder knew of the earlier interest, provided that it was unaware of any negative pledge which prevented the chargor from giving the purchase money security.⁷⁴⁰

14.14.2.6 Floating charges

The position as to floating charges has already been discussed. By way of general summary, if security is held by way of a floating charge then essentially it will concede priority to almost every other competing interest in the assets covered by the charge, so long as such an interest was acquired in circumstances that were within the ordinary course of business of the chargor (which is a concept that has been interpreted very widely) and before the charge crystallised, subject to the holder of the competing interest not having notice of a negative pledge which prevented the chargor from creating that interest.⁷⁴¹ Even after crystallisation, the holder of the charge must defer to a number of other interests that are preferred before it by statute.

14.14.2.6.1 If the competing interest was acquired after the charge had crystallised then the position is assessed by treating the charge as a fixed equitable charge from the time of crystallisation. However, for the purpose of determining if the holder of the other competing interest had notice of the crystallised charge, it is notice of the fact of crystallisation that is the relevant issue as, otherwise, such a holder will only have notice of a floating charge and the apparent entitlement of the chargor to deal with its assets in the ordinary course of its business. It may also be arguable that if the chargee permits the chargor to continue to deal with the charged assets after the charge has crystallised, the chargee may be precluded from denying the chargor's entitlement to do so.

14.14.2.7 Priority agreements

As mentioned above, the parties with competing interests in an asset may agree as to the order in which their respective interests will rank under a priority agreement, and such an agreement will normally bind them to what they have agreed.⁷⁴² The parties to such an agreement should bear in mind the potential pitfall of the decision in *Re Portbase Clothing Ltd*⁷⁴³ which has been previously discussed. In that case it was held that where, by agreement, the fixed chargee conferred priority upon a floating chargee, the preferential creditors could assert their statutory priority ahead of both charges. The same result would apply in favour of the liquidator for his liquidation expenses under section 176ZA of the Insolvency Act 1986 and the right of unsecured creditors under section 176A of the Insolvency Act 1986.

⁷³⁹ For an argument that the doctrine of purchase money security interest is not a coherent or certain doctrine under English law, see R Boadle, 'A Purchase Money Security Interest in UK Law?' [2014] LMCLQ 76. See also L Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 2013 5th edn) paras 5-63 to 5-67.

⁷⁴⁰ See Lord Oliver in *Abbey National Building Society v Cann* [1991] 1 AC 56, at 89-93 and Jonathan Parker LJ in *Whale v Viasystems Technograph Ltd* [2002] EWCA Civ 480.

⁷⁴¹ See 14.6.8.2..

⁷⁴² *Cheah Theam Swee v Equiticorp Finance Group Ltd* [1992] AC 472. See also s 94(1)(a) of the Law of Property Act 1925.

⁷⁴³ [1993] Ch 388.

14.14.3 Goods

Turning now to priorities concerning competing interests in goods (except for ships and aircraft where the interests are registered on the relevant register and other than where one such interest is by way of a floating charge) the starting point is the '*nemo dat*' rule outlined above. An example of this rule is to be found in *The Shizelle*⁷⁴⁴ which was a case concerning a ship that fell outside the regime for the registration of ships. It was held that where a legal mortgage had been granted, the owner (having, via the mortgage, divested itself of the legal title in the vessel) could not confer a later legal interest by way of sale. Accordingly, a later purchaser took subject to the mortgage, even though he was unaware of the mortgage and, in fact, could not have discovered it.⁷⁴⁵

14.14.3.1 There are exceptions to the *nemo dat* rule in the Sale of Goods Act 1979 and the Factors Act 1889,⁷⁴⁶ as well as in Part III of the Hire Purchase Act 1964 in relation to motor vehicles. Further difficulties can arise for an owner of goods in relation to the rights of lien holders and the loss of title through goods becoming fixtures and incorporated in land or where the goods are mixed with or incorporated into other goods. These matters are discussed in Chapter 15.

14.14.3.2 The next rule is that a bona fide purchaser (a purchaser being a person who has given value, who could be an outright purchaser or a person taking security) of the legal estate in goods, who takes without notice of an earlier equitable interest, will prevail. Here, constructive notice would be relevant.

14.14.3.3 In the absence of the application of the previous rules, priority will be governed by the residual rules, of which the most salient is likely to be that the first in time will prevail, unless it is defeated by a purchase money security interest.

14.14.4 Debts

The position as to competing priorities in debts is discussed in Chapter 12.

14.14.5 Further advances

The above has referred to the priority position of the holder of security for securing a fixed sum or advance. There are special rules to deal with priorities where the holder of a fixed security with priority learns, before it makes a further advance, of another fixed security or purchase interest in the charged assets,⁷⁴⁷ which will now be discussed.

14.14.5.1 Section 94(3) of the Law of Property Act 1925 abolished the old general law concept of 'tacking', under which a person with security for a specific advance might in certain limited circumstances have been able to use its security to

⁷⁴⁴ [1992] 2 Lloyd's Rep 444.

⁷⁴⁵ This still seems to be the rule despite section 24 Sale of Goods Act 1979, since this only relates to a seller in possession and sale is specifically stated not to include a mortgage (section 62(4) Sale of Goods Act 1979)

⁷⁴⁶ I.e. s 24 of the Sale of Goods Act 1979 and s 8 of the Factors Act 1889 (a further disposition by a seller who remains in possession), and s 25(1) of the Sale of Goods Act and s 9 of the Factors Act (a disposition by a purchaser or a person who has agreed to buy and obtained possession).

⁷⁴⁷ What follows does not deal with the priority of the proprietor of a registered charge over registered land, to which the provisions of s 49 of the Land Registration Act 2002 apply.

cover further indebtedness of a borrower.⁷⁴⁸ The previous concept of tacking was replaced by section 94(1) of the Law of Property Act 1925, which provides that the holder of a prior ranking security will continue to enjoy priority over a subsequently ranking security for any further advance it makes if it meets any one of three conditions, namely:

- (a) that it was unaware of the other security at the time of making the advance;
- (b) if the security instrument obliges it to make the further advance; or
- (c) if there is an agreement between the security holders which continues the priority of the prior security holder.

14.14.5.2 There are a number of difficulties in the application of the section.

14.14.5.2.1 First, section 94(1) refers to further ‘advances’ that are made by the prior ranking security holder. It is not clear if this would also cover other financial accommodation that is granted by it or other obligations that become due to it by the chargor. Nor is it clear if the section would apply where the security secures a guarantee in circumstances where advances were being made to a third party in reliance upon the guarantee.

14.14.5.2.2 Secondly, it is uncertain if the priority would be lost only if the prior security holder had actual notice of the subsequent security or if constructive notice would be sufficient. It is submitted that the latter construction would be unjust, as it would, for instance, have the consequence that the security holder would have to conduct a search each time it wished to make an advance in case a later security had been registered at Companies House.

14.14.5.2.3 Thirdly, the provision in section 94(1) that refers to an obligation to make the further advance provides for the obligation to be contained in the security instrument itself, not just somewhere else, and it must be an obligation to make the further advance, not simply a discretion to do so. Hence, if an event of default has occurred and the lender has the contractual right to refuse to make an advance, there will not be an obligation to make the advance.

14.14.5.2.4 Fourthly, if the prior security holder cannot claim the benefit of protection under section 94(1) then the risk that the prior security holder has of losing its priority for further advances may be accentuated by the operation of the rule in *Clayton’s case*.⁷⁴⁹ Accordingly, if the borrower makes payments into its account, such payments would have the effect under the rule of paying off the indebtedness incurred on that account before the prior security holder received notice of the later security.⁷⁵⁰ This can be overcome by the prior security holder ruling off the account and opening a new account from which further advances are made and into which repayments are credited.

⁷⁴⁸ As, for instance, used to be case under the rule in *Hopkinson v Rolt* (1861) 9 HL Cas 514. It has been held, however, that s 94(3) did not also have the effect of abolishing the doctrine of *tabula in naufragio* in cases that did not involve a mortgagee. Under that doctrine, the holder of an equitable interest in a tangible asset that was second in time could, by getting in the legal interest, overreach an earlier equitable interest of which the holder had no notice at the time it acquired its own equitable interest: see *McCarthy & Stone Ltd v Julian S Hodge & Co Ltd* [1971] 1 WLR 1547, 1556.

⁷⁴⁹ *Devaynes v Noble, Clayton’s Case* (1816) LJ Ch 256, 35 ER 767.

⁷⁵⁰ This was the position under the general law before s 94: see *Deeley v Lloyds Bank Ltd* [1912] AC 756.

14.14.5.2.5 Finally, section 94(1) only applies to a situation where there are competing security interests. It does not apply if the later interest is that of a purchaser. This final situation was addressed, however, by Slade J in *Siebe Gorman & Co Ltd v Barclays Bank Ltd*.⁷⁵¹ His Lordship held that it would be inequitable to allow the security holder to assert its priority for advances it made with notice of the purchaser's interest, to the detriment of the purchaser, when it had not been obliged to make those advances. It is not clear what the position would be if the security holder was obliged to make the further advances despite having notice of the subsequent interest. It had been held at common law⁷⁵² that the further advances would not have priority, although it would appear to follow from Slade J's reasoning in the *Siebe Gorman* case that the security holder should be able to assert its priority for further advances made in those circumstances.

14.15 Subordination

14.15.1 Introduction

Subordination is a process by which an unsecured creditor (or creditors) agrees to subordinate its right to payment by a debtor, particularly in an insolvency of the debtor, behind the claims of one or more other unsecured creditors. The subordinated creditor is often referred to as the 'junior creditor' and the indebtedness due to the junior creditor (including principal and interest) is referred to as the 'junior debt'. The other creditors in whose favour the subordination exists are called the 'senior creditors' and their debt is referred to as the 'senior debt'.

14.15.1.1 Subordination has the effect that if there are any assets of the debtor available for distribution to unsecured creditors, the junior creditor will only be entitled to receive and retain payments in the distribution with respect to the junior debt once the senior creditors have been paid out in full for the senior debt. Accordingly, it is not a matter that concerns rights in security or of regulating such rights. By contrast, an agreement as to priorities concerns the competing interests of secured creditors under their respective securities and how those interests should rank. Such priority agreements, which are sometimes also referred to as subordination⁷⁵³, have been discussed above, so the term 'subordination' is used here to refer to subordination of unsecured debt. Although subordination does not involve matters of security, it is still a matter of relevant interest and it is convenient to discuss it at this point.

14.15.1.2 If the junior creditor agrees to put its claims with respect to the junior debt behind those of all the other creditors of a debtor (except, perhaps, other subordinated creditors) then the consequence will be that its junior debt will have the appearance of a form of quasi-equity, ranking just ahead of the claims of the shareholders in a winding up of the debtor. It is not correct, however, to treat

⁷⁵¹ [1979] 2 Lloyd's Rep 142. The case is famous for dealing with the question whether it was possible for a fixed charge to be taken over a company's book debts. It is not so well known for its decision on the issue presently under discussion. The effect of the decision on this point meant that the bank really obtained a pyrrhic victory, as nearly all of the benefit of having a fixed charge was lost to the priority gained by the purchaser of the relevant debts, as the vast majority of the outstanding indebtedness secured to the bank had arisen after the bank received notice of the assignment.

⁷⁵² *West v Williams* [1899] 1 Ch 132.

⁷⁵³ See L Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 5th edn 2013) at para 1-86.

subordinated debt as being assimilated to equity, for a number of reasons. In the first place, because it is debt that still ranks ahead of the claims of the shareholders in a distribution upon winding up of the debtor. Secondly, subordinated debt can carry a contractual right to interest, whereas dividends can only be paid out of distributable profits and certain reserves. Thirdly, a repayment of subordinated debt does not amount to a reduction of a company's capital, which can only be achieved in accordance with the requirements of the Companies Act 2006. Fourthly, subordinated debt can be issued at a discount, whereas share capital cannot be issued at a discount.⁷⁵⁴ Fifthly, the tax treatment of interest that is payable on subordinated debt is likely to be different to that which applies to dividends on shares. Finally, to the extent that the company is a worthwhile and profitable enterprise, the shareholders are likely to make a greater return upon their investment than the holders of debt. For that reason, there is an incentive to keep the number of shareholders limited by arranging for funding via a subordinated debt issue.⁷⁵⁵

14.15.1.3 Subordinated debt may comprise loans as well as capital markets debt issues. It is often used to provide a part of private equity financing, as one or more of the layers of debt to fund the acquisition. The thought is that some investors will be prepared to take a greater level of risk in return for more profitable rewards via higher interest rates on the debt. If they do so then that will encourage others to provide funding that is less risky, although the safer debt does not carry such a high return. The sense of such freestyle thinking has been sorely tested by the crisis in the world's financial markets in the second part of 2007, although the structures that were used before that time are now commonplace again. Subordinated debt may also be used as a method of providing funds within a group of companies, as an alternative to the parent company injecting the funds through a subscription of share capital. Subordination also occurs in some forms of guarantee, by which the guarantor agrees not to compete with the creditor by proving in the winding up of the primary debtor, and to subordinate its claims against the primary debtor behind those of the creditor. This is particularly important if the guarantee does not cover the whole of the indebtedness of the primary debtor to the creditor. Subordinated debt may also be issued for regulatory purposes, as it may qualify as part of regulatory capital in computing capital adequacy ratios and requirements.

14.15.1.4 The subordination may be in favour of all of the debtor's other creditors or only one or a particular class of them. The former is likely to be the case when subordination is used to achieve a regulatory capital requirement or in situations where it is wished to encourage third parties to grant credit to the debtor, whereas the latter is more likely to occur in private financing transactions where it is simply a matter of ranking the claims of the various debt holders.

14.15.1.5 Something similar to subordination can be achieved through the use of a corporate group structure. In such a structure, debt could be raised by a parent company which is then passed down to its subsidiary, either by a subscription for shares in the subsidiary or by making a subordinated loan to the subsidiary. By virtue of the legal distinction between the two entities, the creditors of the subsidiary would have a first claim against it before the claim of the parent. Assuming that the only

⁷⁵⁴ S 580 of the Companies Act 2006.

⁷⁵⁵ There has been considerable development of 'hybrid' securities in the capital markets using the concept of subordinated debt for the reasons in the text, see L Gullifer and J Payne, *Corporate Finance Law : Principles and Policy* (2nd edn, Hart Publishing 2015), 2.4.

asset of the parent was its investment in the subsidiary, the debt of the parent would, in a practical sense, be dependent upon receipts from the subsidiary which, in turn, would only be payable after the subsidiary's own creditors had been satisfied. By process of similar reasoning, lenders to a subsidiary company will rank ahead of the claims of the parent company as a shareholder in the subsidiary.⁷⁵⁶

14.15.2 Types of subordination arrangement

14.15.2.1 There are two principal methods of achieving a subordination as between creditors of the same debtor. Sometimes a combination of these methods might be appropriate as, for instance, by providing for the junior creditor to turn over to the senior creditor any rights it has and any payment it receives, so as to cover the possibility that the contingent debt method fails (whether wilfully or otherwise) to achieve what is required.

As a preliminary matter, it is also necessary to determine which of the indebtedness that might be owing to the junior creditor should be treated as junior debt. This will not cause a difficulty where the junior debt is to comprise all such indebtedness. The position will be more problematic where only part of that indebtedness is to be treated as junior debt. In such a case it will be necessary to ensure that the junior creditor is not unduly favoured in receiving payments of its unsubordinated debt and that junior debt cannot surreptitiously be paid in the guise of being unsubordinated debt.

14.15.2.2 Turnover subordination and subordination trusts

The first method is often referred to as 'turnover subordination'. Under it, the junior creditor agrees to account to the senior creditor, or to turn over to the senior creditor, the benefit it has of the junior debt in specified circumstances, particularly if the debtor has become subject to insolvency proceedings. This may be achieved by a purely contractual arrangement, but the senior creditor will then be taking the risk that the contractual arrangements will wither in an insolvency of the junior creditor. For that reason, the senior creditor would usually prefer that the arrangement should take the form of a subordination trust, by which the junior creditor undertakes to hold its rights and any payment that it receives on trust for the senior creditor. An example of such a trust can be seen in *Re British and Commonwealth Holdings PLC (No 3)*.⁷⁵⁷ Where the junior debt is comprised in a bond issue, then the trustee for the bond holders can be joined in the arrangement, so that the trust deed will provide that its obligations under the subordination trust, including as to making distributions, will take precedence over those in favour of the bond holders. It is advisable that the senior creditor should possess authority, preferably in the form of a power of attorney, to take action on behalf of the junior creditor with respect to the junior debt, including lodging proofs and pursuing claims. If the senior creditors comprise all of the other unsecured creditors of the debtor then the trustee or junior creditor can be directed to make payment to the liquidator of the debtor for distribution by him amongst the senior creditors. Similarly, a subordination trust could be in favour of a trustee on behalf of the senior creditors in a case where there were more than one such creditor.

⁷⁵⁶ Structural subordination by this method is particularly common, among other places, in leveraged buyout involving private equity.

⁷⁵⁷ [1992] 1 WLR 672.

14.15.2.3 Contingent debt subordination

By this method, it is a term of the contract under which the junior debt arises, usually reinforced by agreement between all the parties, that in the event that the debtor is subject to insolvency proceedings, the junior debt will only be payable to the junior creditor if the senior creditor has been paid out in full. The junior creditor will also usually agree not to claim against the debtor or prove in its insolvency whilst any amount of the senior debt remains outstanding. An example of this type of subordination will be found in *Re Maxwell Communications Corp PLC (No 2)*,⁷⁵⁸ where the relevant governing law of the jurisdiction concerned was unable to accommodate a subordination trust. This method of subordination is not suitable where there are unsecured creditors of the debtor who are not senior creditors. This is because the effect of the arrangement is not to direct the junior creditor's share to the senior creditors but, in effect, to swell the pot that is available for distribution to all the unsecured creditors other than the junior creditor. In consequence, it will usually also have the effect of prolonging the subordination of the junior creditor's claims.

14.15.2.4 Situations outside the insolvency of the debtor

Strictly speaking, subordination looks to the situation that will apply in the debtor's insolvency. For practical reasons, however, it might be desirable to extend any restrictions and turn over obligations that apply with respect to payments that fall due to the junior creditor so that they, or something to similar effect, will also apply even when the debtor has not entered insolvency proceedings. Accordingly, a well drafted subordination agreement will impose various tests and conditions that have to be met in the ordinary course before the debtor may make, or the junior creditor is entitled to receive or retain, payments of interest, fees and the like, and repayments of principal. Such tests will usually address:

- (i) the debtor's solvency at the time the payment falls due;
- (ii) that there are sufficient reserves which are held by the debtor and available to pay the indebtedness due to the senior creditors as measured and projected over a certain period of time; and
- (iii) that there has been no actual or anticipated default by the borrower in meeting its obligations under the relevant agreements between it and the senior creditors.

14.15.2.5 It is also desirable to ensure that in a financial re-construction of the debtor and its liabilities, the position of the junior creditor is carried through into the new arrangements. It may also be necessary to consider the ability of the junior creditor to vote as a separate class and to provide that it should vote in accordance with the directions of the senior creditors.

14.15.3 Legal issues that arise in connection with subordination

There are a number of legal issues that arise in connection with subordination arrangements, which will now be discussed. Some of these issues concern matters that relate to the relationships that will exist between the junior creditor, the debtor, and the senior creditor; others would arise in an insolvency of the debtor; and yet others of them concern issues that might arise in an insolvency of the junior creditor. One consequence of this is the necessity to keep in mind when considering these issues the

⁷⁵⁸ [1993] 1 WLR 1402.

possibility that either or both of the debtor and the junior creditor might enter insolvency proceedings which may remain current.

14.15.3.1 Pari passu distribution in a winding up of the debtor

It is rather surprising that it took a relatively long time for English law to determine if subordination arrangements might offend against the *pari passu* principle, which is encapsulated in sections 107 and 328(3) of the Insolvency Act 1986 and in Rule 4.181 of the Insolvency Rules 1986. An arrangement which would have the consequence of subverting that principle is void.⁷⁵⁹ It had been argued that the intended effect of a subordination was to subvert the principle and was therefore ineffective, because the subordination had the effect that the junior creditor would rank behind the senior creditors in a winding up or bankruptcy of the debtor, rather than equally with them.

14.15.3.1.1 A series of cases beginning in the early 1990s has now established the validity of the concept of subordination in English law.⁷⁶⁰ Two early cases, which actually concerned issues arising in schemes of arrangement, so were not of binding authority in relation to a bankruptcy or winding up, were the decisions of Vinelott J in *Re British and Commonwealth Holdings PLC (No. 3)*⁷⁶¹ and *Re Maxwell Communications Corp. PLC (No.2)*.⁷⁶² In the first of those cases, his Lordship upheld the validity of a subordination trust. In the second case, his Lordship upheld the validity of a contingent debt subordination. More recently, both types of subordination arrangement have been held valid in a winding up of a debtor in *Re SSSL Realisations (2002) Ltd; Manning v AIG Europe Ltd*.⁷⁶³ The essential reasoning of those cases is that the *pari passu* principle is intended to prevent the debtor agreeing with one or a few of its creditors to an arrangement which is for the benefit of that one or few creditors but not for the equal benefit of all of its creditors. The principle does not prevent an arrangement by which one or a few creditors agree with the debtor to postpone their rights behind those of other creditors. Furthermore, the Court of Appeal in *Re Lehman Brothers International (Europe)* decided that it is possible for a creditor with a provable debt to agree to a subordination lower down the order of priority, after statutory interest and non-provable liabilities..⁷⁶⁴ It was held that the mandatory provisions of payment of statutory interest in administration and liquidation⁷⁶⁵ could constitute debt “payable or owing by the Borrower” under the terms of the agreement and were not merely directions to the insolvency officer on how to deal with a fund under his control.⁷⁶⁶ It was also confirmed (a point made at

⁷⁵⁹ *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 1 WLR 758; *Revenue and Customs Commissioners v Football League Ltd* [2012] EWHC 1372 (Ch) [4].

⁷⁶⁰ A little earlier, subordination arrangements had been held valid in Australia: *Horne v Chester & Fein Property Developments Pty Ltd* (1987) 5 ACLC 245. See also *Re NIAA Corporation Ltd* (1994) 12 ACLC 64 and *United States Trust Co of New York v Australia & New Zealand Banking Group Ltd* (1995) 17 ACSR 697.

⁷⁶¹ [1992] 1 WLR 672.

⁷⁶² [1993] 1 WLR 1,402.

⁷⁶³ [2004] EWHC 1760 (Ch), [2005] 1BCLC 1 (Lloyd J), upheld [2006] EWCA Civ 7, [2006] Ch 610.

⁷⁶⁴ [2014] EWHC 704 (Ch), [2015] Ch 1, affirmed on this point unanimously [2015] EWCA Civ 485, [2015] BCC 431.

⁷⁶⁵ Rule 2.88(7) of the Insolvency Rules 1986 and section 189(2) of the Insolvency Act 1986

⁷⁶⁶ See also Vinelott J in *In re Maxwell* [1993] 1 WLR 1,402 expressly contemplated that a preferential creditor could agree that his debt would rank equally with the unsecured non-preferential debts, notwithstanding that the payment of preferential debts in priority to the general body of unsecured debts is itself the subject of provisions expressed in mandatory terms: section 175(1) of the Insolvency

the first instance only) that subordination could be effected on a purely contractual basis, rather than a trust, and did not contravene the *pari passu* rules.⁷⁶⁷

14.15.3.2 Insolvency set-off as between the insolvent debtor and the junior creditor

As previously explained, the rules as to insolvency set-off are mandatory in the bankruptcy or winding up of a debtor and they may also come into play in the administration of the debtor, where the administrator proposes to make a distribution to creditors. The question which arises at this point is whether the rules apply where the junior creditor has a liability to the debtor which, but for the subordination, would be taken into account for insolvency set-off purposes. If the set-off is not available then the junior creditor will be forced to pay its liability and it will be unable to reduce the amount of that liability by reference to the set-off. The question assumes that at the time the bankruptcy or winding up commences, the subordination remains in place because the senior creditors have not been paid out.

14.15.3.2.1 In the case of a subordination trust, where the junior creditor has effectively disposed of its rights in the junior debt outright, there will be no mutuality as between the junior creditor and the debtor on which the set-off could be based. The junior creditor would be forced to pay to the liquidator or trustee in bankruptcy the full amount of its liability to the debtor (assuming that its amount is determined). It is submitted that the same consequence should follow if the trust is over all of the junior debt, albeit limited as to the amount recoverable by the senior creditor under it.

14.15.3.2.2 Where the subordination is achieved through the means of a contingent debt arrangement, without the back-up of a subordination trust, it was argued in the previous edition that theoretically the set-off could apply, because contingent liabilities might still be taken into account for the purposes of the set-off. This was recently confirmed by the Court of Appeal.⁷⁶⁸ However, it was said in the previous edition, and these considerations still apply, that such a set-off only arises in particular circumstances. It is necessary to put a value on the contingent debt for the purpose of taking the account of the respective amounts to be set off.⁷⁶⁹ If the senior debt will not be paid out in full then nothing will be payable by the insolvent debtor with respect to the contingent debt, so that no value should be placed on it. The practical consequence would be that there would be nothing available to be set off. The junior creditor would be obliged to pay to the liquidator or trustee in bankruptcy the debt that it owes to the insolvent debtor and no set-off would be available to it to reduce that payment.

14.15.3.2.3 By way of extra precaution, it would be sensible in the subordination arrangements to provide that the junior creditor should account to the senior creditors for the benefit it receives in any set-off that is applied.

Act 1986 (liquidation), which applies also in an administration: paragraph 65(2) of Schedule to the Insolvency Act 1986.

⁷⁶⁷ See David Richards J in *Re Lehman Brothers International (Europe) (in admin)* [2014] EWHC 704 (Ch), [2015] Ch 1 [82]-[85].

⁷⁶⁸ *Re Lehman Brothers International (Europe) (in admin)* [2015] EWCA Civ 485, [2015] BCC 431.

⁷⁶⁹ See Briggs LJ in *Re Lehman Brothers International (Europe) (in admin)* [2015] EWCA Civ 485, [2015] BCC 431 at [152].

14.15.3.3 Participation of the junior creditor in the prescribed part of floating charge property

Section 176A of the Insolvency Act 1986 provides for a prescribed part of the recoveries under a floating charge to be made ‘available for the satisfaction of unsecured debts.’ Under a subordination trust, the junior debt should still qualify to be taken into account under the section as an unsecured debt, and the junior creditor would be required to hold the benefit of any amount it received pursuant to the operation of the section for the senior creditors. The position is not so clear in relation to a contingent debt subordination, because it is arguable that there is no debt due by the debtor to the junior creditor which would qualify to be taken into account for the purposes of the section.

14.15.3.4 Subordination trusts by way of security

This issue concerns whether a subordination trust constitutes a form of third party security that is given by the junior creditor to the senior creditors, over the junior debt, as security for the payment of the senior debt. If so, then the further question that arises is whether the security is registrable as a charge under section 859A of the Companies Act 2006.⁷⁷⁰ If the charge is registrable, and it is not registered, then it will be void in the liquidation or administration of the junior creditor, and it will also be void as against other secured creditors of the junior creditor. Whether or not the charge is registrable, it might also infringe the terms of a negative pledge which the junior creditor has agreed in favour of a third party. In addition, if the trust constitutes security that has been given by the junior creditor, it would be subject to the restrictions and other provisions that would apply to such security in an administration of the junior creditor or if a proposal has been made for a company voluntary arrangement of the junior creditor.⁷⁷¹

14.15.3.4.1 It is possible that a trust which a person declares over the benefit of an asset might be absolute, in the sense that it confers a sole beneficial ownership of the trust property in favour of the beneficiaries and, accordingly, that the trustee gives up all its real rights in the trust property, or a joint beneficial interest in which the trustee holds the trust property jointly for itself and the beneficiary.⁷⁷² Alternatively, such a trust might be held to be by way of charge, even by way of floating charge, because the trustee has not given up all of its interest in the trust property.⁷⁷³ It is also important to remember that in English law security may be given to secure the obligations of a third party without the security giver undertaking a personal obligation to pay the liability for which the security has been given. The essential question in resolving this issue is whether the person that declares the trust (in this case the junior creditor) intends to create an absolute interest (in the whole or part of

⁷⁷⁰ See discussion above.

⁷⁷¹ See para 12(1) of Sched A1, and paras 43 and 44 of Sched B1, to the Insolvency Act 1986.

⁷⁷² The ability of a trustee to declare a trust over part of a fund is supported by a number of recent authorities, see *In the Matter of Lehman Brothers International (Europe) (In Administration)* [2009] EWHC 2545 (Ch) [56]; *Lehman Brothers International (Europe) (in admin)* [2010] EWCA Civ 917 [171]; *Re Lehman Brothers International (Europe) (In Administration)* [2010] EWHC 2914 (Ch) [232]–[239]. See also *Re Kayford Ltd* [1975] 1 WLR 279; *Re Lewis's of Leicester* [1995] BCC 514. For further discussion of the argument in this context, see L Gullifer and J Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, Hart Publishing 2015), 6.4.4.1.1.

⁷⁷³ See Slade J in *Re Bond Worth Ltd* [1980] Ch 228, at 247 and Jonathan Parker J in *Re ILG Travel Ltd* [1996] BCC 21, at 44–45.

the fund) or intends to create a security interest, as demonstrated by the terms of the subordination agreement.

14.15.3.4.2 In the context of a subordination trust, it is unlikely that a junior creditor would give up all of its entitlement in the junior debt, even to the extent of parting with its interest in the debt once the senior creditors had been paid out in full. Thus, the only two possible analyses are that it intends to create a charge, or to declare a trust over part of the fund (namely, the amount it recovers from the debtor). In *Re SSSL Realisations*⁷⁷⁴ Lloyd J held that, on construction of the relevant clause, the trust obligation was limited to the sums due to the senior creditor, and therefore was not a charge.⁷⁷⁵ Even if a charge were created, it would not be registrable if it were a security financial collateral arrangement, which, if it were a charge over the junior creditor's bank account, it could be.⁷⁷⁶

14.15.3.5 The pari passu principle in the insolvency of the junior creditor

In *Re SSSL Realisations (2002) Ltd; Manning v AIG Europe Ltd*⁷⁷⁷ it was also argued that the agreement by the junior creditor to the subordination arrangements might offend against the *pari passu* principle in relation to a bankruptcy or winding up of the junior creditor. The argument was put on the basis that by agreeing that its rights to payment by the debtor would be restricted, the junior creditor had prejudiced its own creditors by making one of its assets unavailable in its own insolvency. The argument was rejected. The *pari passu* principle relates to arrangements which have the effect of putting the claims of certain unsecured creditors of an insolvent debtor, without their consent, behind the claims of other unsecured creditors of that insolvent debtor. The principle has nothing to do with the availability or quality of the assets of the insolvent debtor to meet those claims. In effect, the fact that the asset was impaired by the subordination arrangements agreed by the junior creditor with the senior creditors was not relevant to the application of the *pari passu* principle.⁷⁷⁸ It is worth noting that a similar point was considered by Peter Gibson J in *Carreras Rothman Ltd v Freeman Mathews Treasure Ltd*,⁷⁷⁹ which concerned a company that was in liquidation and which, in relation to a debt that was owed to it, had agreed before the commencement of the liquidation to give up that debt (i.e. to give up the asset being the debt due to it) in return for its former debtor participating in the establishment and funding of a *Quistclose* trust arrangement (see the decision of the House of Lords in *Barclays Bank Ltd v Quistclose Investments Ltd*⁷⁸⁰) in favour of certain debtors of the company.

⁷⁷⁴ [2004] EWHC 1760 (Ch) [49], [51].

⁷⁷⁵ This was upheld by the Court of Appeal in *Re SSSL Realisations, sub nom Squires v AIG Europe (UK) Ltd* [2006] EWCA Civ 7 [122].

⁷⁷⁶ See 14.7.5 for discussion of security financial collateral arrangements.

⁷⁷⁷ [2004] EWHC 1760 (Ch), [2005] 1 BCLC 1 (Lloyd J), upheld [2006] EWCA Civ 7, [2006] Ch 610.

⁷⁷⁸ The anti-deprivation principle might be more appropriate, but is unlikely to be relevant as the deprivation is not triggered by the entry of the junior creditor into insolvency proceedings.

⁷⁷⁹ [1985] Ch 207.

⁷⁸⁰ [1970] AC 567.

14.15.3.6 Disclaimer of a subordination arrangement as an unprofitable contract in the insolvency of the junior creditor

This issue, which particularly concerns the contingent debt aspects of a subordination, was explored by Lloyd J at first instance and by Chadwick LJ in the appeal in *Re SSSL Realisations (2002) Ltd; Manning v AIG Europe Ltd*.⁷⁸¹ The explanation that follows is taken from the judgments of Lloyd J and Chadwick LJ, the latter upholding the judgment of the former.

14.15.3.6.1 The right to disclaim onerous property is exercisable by a trustee in bankruptcy⁷⁸² and by a liquidator.⁷⁸³ The provisions concerning bankruptcy are in much the same terms as those for winding up, so the discussion will concentrate on the provisions that apply in a winding up, principally section 178 of the Insolvency Act 1986. The effect of a disclaimer by a liquidator is that the rights and liabilities of the company in liquidation with respect to the relevant contract or asset are terminated, so that the company will be released from having to make further performance of its obligations under the contract or with respect to the asset. A counterparty that is adversely affected by the disclaimer is given a right to prove for the loss or damage that it sustains, but that will usually be of little real benefit. There is a saving provision as to the associated liabilities of a third party, which has given rise to difficulties in areas such as guarantees of property leases that have been disclaimed.⁷⁸⁴

14.15.3.6.2 Section 178(3) of the Insolvency Act 1986 defines ‘onerous property’ to mean (a) an unprofitable contract or (b) other property which is unsaleable or not readily saleable or which has onerous liabilities attached to it. In light of the definition of ‘Property’ in section 436 of the Act, Lloyd J came to the view that something could only qualify as property within (b) if it involved some element of benefit or entitlement for the person holding it. The obligations of a junior creditor are unlikely to fit that requirement. That view was approved by Chadwick LJ. Accordingly, section 178 should only apply in the case of a subordination by the junior creditor if its liquidator could establish that the relevant subordination arrangement was an unprofitable contract for the junior creditor.

14.15.3.6.3 In relation to the concept of an unprofitable contract, Lloyd J referred to the decision of Chesterman J in the Supreme Court of Queensland, Australia, in *Trans-metro Corporation Ltd v Real Investments Pty Ltd*⁷⁸⁵ in which his Honour, in considering a similar legislative provision, had said that an unprofitable contract was one which imposed on the company in liquidation continuing financial obligations without sufficient reciprocal benefits. It must give rise to prospective liabilities. A contract is not unprofitable merely because it is financially disadvantageous or because the company could have made a better bargain. Contracts that will delay the winding up, which will have to be performed over a substantial period of time and which will involve irrecoverable expenditure are unprofitable. This was approved by

⁷⁸¹ [2004] EWHC 1760 (Ch); [2005] 1BCLC 1, at [56]–[71] (Lloyd J), upheld [2006] EWCA Civ 7; [2006] Ch 610, at [33]–[54].

⁷⁸² Under s 315 of the Insolvency Act 1986.

⁷⁸³ Under s 178 of the Insolvency Act 1986.

⁷⁸⁴ See *Hindcastle v Barbara Attenborough* [1997] AC 70; *Active Estates v Parness* (2002) 36 EG 147; *Scottish Widows v Jane Tripipatkul* [2003] EWHC 1874 (Ch).

⁷⁸⁵ (1999) 17 ACLC 1314.

Chadwick LJ who referred to the decision in the *Transmetro* case, together with a series of other Australian cases which supported the view taken in that case.⁷⁸⁶

14.15.3.6.4 Chadwick LJ also referred to a summary of the purposes for which the power to disclaim is conferred on a liquidator, which had been provided by Professor Sir Roy Goode.⁷⁸⁷ They were, first, to enable the liquidator to bring the liquidation to an end without being held up by continuing obligations under unprofitable contracts,⁷⁸⁸ and secondly, in an insolvent liquidation to avoid the continuance of liabilities which would be payable as expenses of the liquidation to the detriment of unsecured creditors.

14.15.3.6.5 On the facts of the case, Chadwick LJ upheld the finding by Lloyd J that the subordination arrangements entered into by the junior creditor did not amount to an unprofitable contract. Although it was disadvantageous to the interests of the junior creditor's own creditors, it did not impose continuing financial obligations on the junior creditor, it did not give rise to prospective liabilities to be performed by the junior creditor, it did not involve expenditure by the junior creditor, nor did it require performance over a substantial period of time. Furthermore, the junior creditor had obtained its reciprocal benefit from the senior creditor in consideration of entering into the subordination arrangement.

14.15.3.6.6 Chadwick LJ did go on to say, however, that he could envisage circumstances where a subordination arrangement might fall to be considered as an unprofitable contract because future obligations that had to be performed under it were such as to impede the liquidator in realising the junior creditor's property and paying a dividend to its creditors within a reasonable time. He gave as an example a situation (which would be rare) where a junior creditor in a solvent liquidation might be required to provide cash cover against a future obligation it might have to the senior creditor in an amount that was not then capable of being quantified. His Lordship also said that a provision which prevented the junior creditor from proving in the debtor's liquidation might be considered as an unprofitable contract if the facts were such that there was a prospect that at some future date the senior creditor would be paid off so that the restriction on proving would have the effect that the junior creditor had been prevented from proving in the debtor's liquidation for the junior debt.

14.15.3.7 Administration of the junior creditor

If the junior creditor enters administration then the various restrictions that apply to the enforcement of security and pursuing creditors' rights in such an administration will apply.⁷⁸⁹ This will act as a restriction on the action that the senior creditors may take against the junior creditor. Similar restrictions will apply in the case of the moratorium that arises where a proposal has been made for a voluntary arrangement of an eligible company, should the junior creditor be such a company.⁷⁹⁰

⁷⁸⁶ Namely the decisions of Santow J in *Global Television Pty Ltd v Sportsview Australia Pty Ltd* (2000) 35 ACSR 484; Hodgson J in *Rothwells Ltd v Spedley Securities Ltd* (1990) 8 ACLR 783; and Young J in *Dekala Pty Ltd v Perth Land & Leisure Ltd* (1989) 12 ACLR 585.

⁷⁸⁷ *Principles of Corporate Insolvency Law* (3rd edn, 2005), at para 6-20.

⁷⁸⁸ See also Lord Millett in *Re Park Air Services PLC* [2000] 2 AC 172, at 184.

⁷⁸⁹ See, for instance, paras 43 and 44 of Sched B1 to the Insolvency Act 1986.

⁷⁹⁰ See para 12 of Sched A1 to the Insolvency Act 1986.

14.15.3.8 The junior creditor as a surety

Where a subordination trust constitutes a form of third party security, as discussed above, then the junior creditor might be seen as taking on the mantle as a surety for the senior debt. The analogy is less clear in a purely contingent debt arrangement but it is not entirely fanciful. In either case, it is possible that the junior creditor might be able to argue, in principle, that the subordination arrangements were only intended to apply with respect to the circumstances as they existed at the time it entered into the subordination arrangements. Just as a surety is entitled to insist that the underlying agreement as between the creditor and principal debtor, and security and other suretyships, should not be changed or abrogated to the potential detriment of the surety, so also the junior creditor might be entitled to insist that the terms and conditions of the senior debt (and other matters relevant to it) should not be changed or released without its consent. This could be relevant to matters such as the amount and maturity date of the senior debt and other financial conditions that relate to it, as well as other matters that might be material to it, such as the continued existence of guarantees and of subordination arrangements entered into by other junior creditors. If changes occur without the consent of the junior creditor then the junior creditor might be entitled to say that it has been discharged (either in whole or in part) from the obligations and restrictions that apply with respect to it and the junior debt under the subordination arrangements.

14.15.3.8.1 In an attempt to defeat any arguments of that nature which the junior creditor might raise, it would be advisable to include in the subordination arrangements provisions that are similar to those usually found in well drawn forms of guarantee, by which the guarantor effectively consents to changes and amendments, as well as the discharge of security and other sureties, and confirms that its liability under the guarantee will continue unaffected by the occurrence of any such matters.⁷⁹¹ Of course, the junior creditor may not wish to concede a wide amount of liberty in that regard and a negotiated position may have to be found.

14.16 Upsetting Prior Transactions Entered into by an Obligor

14.16.1 The Insolvency Act 1986 (the ‘Act’) provides a number of grounds upon which a transaction which had been previously entered into by an obligor might be upset. All but one of them arises in the context of the liquidation, bankruptcy or administration of the obligor, where the liquidator, trustee, or administrator is given the right to challenge the transaction. The discussion that follows will concentrate on the grounds upon which a transaction might be challenged, but it is important to bear in mind that there are also other provisions of the Act under which liability may be imposed upon the directors and others concerned with an insolvent company in relation to misfeasance and other wrongful action on their part which may have caused loss to the company and its creditors.⁷⁹² For simplicity, the discussion will concentrate on the grounds for upsetting transactions entered into by a corporate obligor, but there are similar provisions that apply in the case of an individual.

⁷⁹¹ See generally the discussion in Chap 16.

⁷⁹² See ss 206–214 of the Insolvency Act 1986.

14.16.2 Avoidance of dispositions of property in a compulsory winding up

Section 127(1) of the Act⁷⁹³ provides that where a company is being wound up by the court, a disposition by a company of its property (and any transfer of its shares or alteration in the status of its members) made after the commencement of its winding up is void unless validated by the court.⁷⁹⁴ Generally, as validation orders are not awarded unless the transaction was in good faith and did not result in a significant reduction in the value of assets available to the creditors, courts are slow to award them.⁷⁹⁵ A disposition would include a payment or the granting of any interest in property of the company, whether outright or by way of security.⁷⁹⁶ For this purpose, the winding up is deemed to have commenced on the date on which the petition for winding up was presented or, if earlier, the date of the passing of a resolution for winding up. A number of points arise in considering section 127(1).

14.16.2.1 A payment into a company's overdrawn account with its bank constitutes a disposition in favour of the bank for the purposes of section 127(1).⁷⁹⁷ This is in contrast to a payment into a bank account that was in credit.⁷⁹⁸ When a bank honours a cheque drawn by a company on its account with the bank, where the account is in credit, that is a disposition by the company in favour of the payee but the bank will not incur liability under section 127(1) for acting in accordance with its mandate. The same would probably apply if the account was overdrawn.⁷⁹⁹

14.16.2.2 The following principles should apply when the court is deciding if it should grant a validation order:⁸⁰⁰

- (i) the court has a discretion, which is at large;
- (ii) the basic principle underlying the purpose of the section is that of achieving a *pari passu* distribution as between all of the unsecured creditors of the insolvent company for the benefit of the general body of creditors and to prevent the dissipation of the company's assets contrary to that purpose;⁸⁰¹
- (iii) the court should ensure that the interests of the unsecured creditors are not prejudiced;
- (iv) except unusually where it was in the interests of creditors generally, the court should not validate a transaction which would have the effect of one pre-

⁷⁹³ For bankruptcy see s 284 of the Insolvency Act 1986.

⁷⁹⁴ The position is far less severe with respect to a company that is in voluntary winding up which has not been converted into a compulsory winding up: see ss 87 and 88 of the Act.

⁷⁹⁵ *Wilson v SMC Properties Ltd* [2015] EWHC 870 (Ch), [2015] 2 BCLC 17.

⁷⁹⁶ But it must be property in which the company has a beneficial interest: *Re Margart Pty Ltd* (1985) 9 ACLR 269; *Re Branston & Gothard Ltd* [1999] BPIR 466. The receipt by the chargee of the proceeds of a disposition of charged property would not amount to a disposition in favour of the chargee because of the chargee's pre-existing equitable interest in the proceeds: *Re Margart Pty Ltd* (1985) 9 ACLR 269.

⁷⁹⁷ *Re Gray's Inn Construction Co Ltd* [1980] 1 WLR 711.

⁷⁹⁸ *Re Barn Crown Ltd* [1995] 1 WLR 147.

⁷⁹⁹ *Hollcourt (Contracts) Ltd v Bank of Ireland* [2001] Ch 555.

⁸⁰⁰ These principles were set out in *Rose v AIB Group (UK) PLC* [2003] EWHC 1737, [2003] 1 WLR 2791, which drew upon *Re Gray's Inn Construction Co Ltd* [1980] 1 WLR 711 and *Denney v John Hudson & Co Ltd* [1992] BCLC 910. For a summary of approaches to validation orders see *Wilson v SMC Properties Ltd* [2015] EWHC 870 (Ch), [2015] 2 BCLC 173.

⁸⁰¹ See also Lightman J in *Coutts & Co v Stock* [2000] 1 WLR 906, which was approved by the Court of Appeal in *Hollcourt (Contracts) Ltd v Bank of Ireland* [2001] Ch 555, Mr Registrar Briggs in *Wilson v SMC Properties Ltd* [2015] EWHC 870 (Ch); [2015] 2 BCLC 173, at [20]-[32].

liquidation creditor being paid off in full where other creditors would only receive a dividend⁸⁰²; and

- (v) a disposition carried out by the parties in good faith at a time when they were unaware that a petition had been presented might be validated unless there were grounds for thinking that the transaction was an attempt to prefer the donee ('prefer' in this sense not having its technical meaning under the Act but, rather, something generally having the effect of circumventing the *pari passu* rule). In this regard, however, good faith by itself is not sufficient to justify validation.

There are two further requirements that should be met. First, that the parties were acting in the ordinary course of business and secondly, that the relevant transactions were likely to be for the benefit of the creditors generally. The second point demonstrates that the decision of the Court of Appeal in *Re Gray's Inn Construction Co. Ltd*⁸⁰³ should not be taken as authority that a court will always validate payments made into an overdrawn bank account where the payments were apparently in the ordinary course of business.

14.16.2.3 The claim by a liquidator for recoupment of an invalid payment or other disposition is in the nature of a restitutionary claim, as section 127(1) does not provide a statutory right to recover assets that have been wrongfully disposed of by the company.⁸⁰⁴ As the claim is restitutionary in nature, the recipient of a disposition may be able to assert a defence based upon a change of its position. Such a defence would be available where the recipient was unaware or had genuinely overlooked the fact, when it changed its position, that the payment might be invalid or where it had acted upon an assurance from the liquidator that he would not claim against the recipient.⁸⁰⁵

14.16.2.4 It has been suggested that if the claim which is pursued by the liquidator relates to property which had been the subject of an uncrystallised floating charge when it was disposed of then the charge will apply to what is recovered by the liquidator under section 127(1) of the Act.⁸⁰⁶ It is submitted, with respect, that this is incorrect, at least in the situation where the original disposition was absolute and fell within the broadly understood concept of being in the ordinary course of the company's business. If so, then the charge would have ceased to apply to the relevant property at the time the disposition took place. As has been seen above, the claim of the liquidator is restitutionary in nature and does not automatically give a full right to recovery. Defences, such as based upon a change of position, may be asserted to defeat the claim or, alternatively, the court may validate the disposition. Accordingly, whilst the word 'void' is used in the section, the consequence is not to treat the disposition as being void *ab initio* so that the disposition is treated as never having occurred with the consequence that the property must be returned *in specie*, but merely to give the liquidator a claim which he can pursue. The claim vests in him.

⁸⁰² Similarly, a validation order is not awarded to a company where the only reason it is sought is to buy time to pay off liability to HM Revenue & Customs as the company's creditor, see *RC Brewery Ltd v Revenue and Customs Commissioners* [2013] EWHC 1184 (Ch).

⁸⁰³ [1980] 1 WLR 711.

⁸⁰⁴ *Hollicourt (Contracts) Ltd v Bank of Ireland* [2001] Ch 555; *Rose v AIB Group (UK) PLC* [2003] EWHC 1737, [2003] 1 WLR 2791.

⁸⁰⁵ Such a defence may be difficult to make out on the facts: *Rose v AIB Group (UK) PLC* [2003] EWHC 1737, [2003] 1 WLR 2791.

⁸⁰⁶ *Mond v Hammond Suddards* [1996] 2 BCLC 470. The point was accepted on appeal: *Re RS&M Engineering Co Ltd, Mond v Hammond Suddards* [2000] Ch 40, at 50.

The chargee has no right to bring the proceedings, nor can it compel the liquidator to bring them. If he does pursue the claim, he does it for the benefit of the general body of the company's unsecured creditors and not to restore to the company the property, nor to restore to the chargee the charged property, as if it had never been the subject of the original disposition.

14.16.3 Transactions at an undervalue

Section 238 of the Act⁸⁰⁷ concerns transactions at an undervalue that a company may have entered into at a relevant time prior to its entry into winding up or administration. The liquidator or administrator is given power to challenge any such transaction. Section 238 is addressed in more detail in Chapter 16 and the reader is referred to the discussion in that chapter for a fuller explanation of the section.

14.16.3.1 By way of brief summary, the section applies if the debtor company has entered into a transaction at an undervalue at a 'relevant time' (which, essentially, is a period of two years prior to the onset of the insolvency proceedings,⁸⁰⁸ provided that the company met the relevant insolvency tests⁸⁰⁹ when the transaction occurred or became insolvent in consequence of the transaction). The court has a wide amount of discretion as to the order that it might make if such a transaction has occurred.⁸¹⁰

14.16.3.2 A transaction at an undervalue entered into by a debtor company is defined to be one which meets either of the following tests:

- (a) the debtor company makes a gift to another person or otherwise enters into a transaction with that person on terms that provided for the company to receive no consideration, or
- (b) the debtor company enters into a transaction with that other person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company.

It should be noted that the term "transaction" is defined widely in section 436 of the Insolvency Act as including a gift, agreement or arrangement and that it must be the company (not, for example, a trustee holding trust money for it or its managing director) that enters into the relevant transaction, which means the company must take some step or show an act of participation.⁸¹¹

⁸⁰⁷ The comparable section for bankruptcy is s 339 of the Insolvency Act 1986. Similar provisions will also be found in s 423 of that Act (transactions defrauding creditors), which applies to both companies and individuals.

⁸⁰⁸ The period of two years is laid down in s 240 of the Act, but note also the alternative period provided in s 240(1)(c) and (d) (to which the solvency tests do not apply). The period is five years for insolvent individuals: see s 341 of the Act.

⁸⁰⁹ Section 123 of the Insolvency Act 1986. The relationship between the two tests: the 'cash-flow' test and the 'balance-sheet' test was considered by Lewison LJ in *Re Casa Estates (UK) v Bucci* [2014] EWCA Civ 383, [2014] BCC 269 [27]. To the extent that liabilities are taken into account it is necessary to consider future and contingent liabilities and, in assessing them, to consider whether and when they are likely to fall due: see *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc* [2013] UKSC 28, [2013] 3 All ER 271.

⁸¹⁰ The powers of the court to make an order are discussed below.

⁸¹¹ A sale by a bankrupt's mortgagee was not a sale 'entered into' by the bankrupt: see Jonathan Parker J in *Re Brabon, Treharne v Brabon* [2001] 1 BCLC 11; a dishonest transfer of company's funds by the managing director into his own account was not a company's act: see Lord Phillips in *Stone & Rolls Ltd (in liquidation) v Moore Stephens (a firm)* [2009] UKHL 39, [2009] 1 AC 1391 at [46]; a trustee's

14.16.3.3 The court may not make an order, however, if it can be shown that the debtor company entered into the transaction:⁸¹²

- (a) . . . in good faith and for the purpose of carrying on its business, and
- (b) at the time it did so there were reasonable grounds for believing that the transaction would benefit the company.

14.16.3.4 Giving security

There has been some debate as to whether the giving of security could ever amount to a transaction at an undervalue. In *Hill (as Trustee in Bankruptcy of Nurkowski) v Spread Trustee Co Ltd*,⁸¹³ which was a case that concerned section 423 of the Act but in which the same two limbs of the definition are used, the Court of Appeal held that the giving of security without the receipt of any consideration in return will fall within the first limb of the definition. In that case, security had been given for an existing debt. There had been no consideration provided to the security giver for doing so, such as by way of a forbearance in suing for the debt.

14.16.3.4.1 With respect to the second limb of the definition, Millett J in *Re MC Bacon Ltd*⁸¹⁴ said that the granting of security could not constitute a transaction at an undervalue within the second limb. This was because the granting of the security did not deplete the debtor company's assets nor diminish their value. The debtor retained the right to redeem, sell, or remortgage the charged assets. All it lost in giving the security was the ability to apply the assets otherwise than in satisfaction of the secured debt. That was not something which was capable of valuation in monetary terms and was not customarily disposed of for value.

14.16.3.4.2 The view that had been taken by Millett J was contradicted by Arden LJ in *obiter* comments in *Hill (as Trustee in Bankruptcy of Nurkowski) v Spread Trustee Co Ltd*.⁸¹⁵ Her Ladyship expressed the view that the granting of security by the debtor could amount to a transaction at an undervalue within the second limb of the definition. She said that the definition did not necessarily require that there should be a diminution in the debtor's assets or in their value, nor did it require that there was a grant of proprietary rights by the debtor. A grant by the debtor of other rights could be considered as falling within the definition and so could constitute the giving of consideration by the debtor. In any event, she considered that the grant of security might involve a disposition of property rights by the debtor. Whilst the grant of security does not involve an outright transfer of ownership in assets so as to deprive the debtor of its physical connection with them (although a legal or equitable mortgage does involve a notional transfer of title, subject to the debtor's equity of redemption), it does involve the granting of a right of recourse to the assets and a commensurate granting of priority in the assets over the claims of other creditors of

transfer of trust money held for a company was not the company's act, see Kitchin LJ in *Re Ovenden Colbert Printers Ltd; Hunt v Hosking* [2013] EWCA Civ 1408, [2014] 1 B.C.L.C. 291, at [32]-[38].

⁸¹² It should be noted that there is no equivalent provision in s 339 of the Act in relation to insolvent individuals.

⁸¹³ [2006] EWCA Civ 542; [2006] BCC 646.

⁸¹⁴ [1990] BCC 78, at 91-92, [1990] BCLC 324, at 340-341. The view expressed by Millett J was approved by Balcombe LJ in the Court of Appeal in *Menzies v National Bank of Kuwait SAK* [1994] BCC 119, at 129.

⁸¹⁵ [2006] EWCA Civ 542; [2006] BCC 646, at [138].

the debtor.⁸¹⁶ There was no reason why the value of the right to have such recourse and to such priority should be left out of the account in determining if there had been a transaction at an undervalue.

14.16.3.4.3 If the view expressed by Arden LJ is correct then a rather curious consequence could follow. This consequence is that the security might be capable of challenge under section 238 when it is not possible, or it is more difficult, to mount a successful challenge under section 239, which is the section that is more appropriately tailored to challenging the validity of security. For instance, the security may have been granted outside the more limited time period that might apply under section 239, or it may not be possible to establish the necessary motive on the part of the company in terms of the desire to prefer the recipient of the security. In that regard, the task of the liquidator or administrator is easier under section 238 than under section 239. Under section 239, the liquidator or administrator has the task of showing that the requisite desire existed on the part of the company. Under section 238, the liquidator or administrator has to establish that a transaction at an undervalue took place but it is then for the person that is seeking to uphold the transaction to defend it by showing that in entering into the transaction the company did so both (i) subjectively in good faith and for the purpose of carrying on its business, and (ii) objectively, in that there were reasonable grounds to believe the transaction would be for the company's benefit.

14.16.4 Preferences

Section 239 of the Act⁸¹⁷ concerns preferences that a company may have given in favour of another person at a 'relevant time' prior to its entry into winding up or administration. The liquidator or administrator is given power to challenge any such preference and the court is given a wide discretion as to the order which can be made to restore the position to what it would have been had the preference not been given.⁸¹⁸

14.16.4.1 There are three essential ingredients that must be established by the liquidator or administrator before an order may be made. First, that the preference was given by the company at a relevant time. Second, that what occurred constituted a preference in favour of another person. Thirdly, that the company was influenced by a desire to prefer the beneficiary of the preference. Each of those requirements will now be examined.

14.16.4.2 Relevant time

Subject to meeting the insolvency tests⁸¹⁹, a relevant time can be any of three possible periods. First, it is a period of two years prior to the onset of the insolvency proceedings, if the person preferred was connected with the company.⁸²⁰ Secondly, it is a period of six months before the onset of the insolvency proceedings.⁸²¹ Thirdly, it is the preliminary period before the appointment of an administrator.⁸²² However, it

⁸¹⁶ As to the consequences of granting security, Arden LJ referred to what was said by Lord Hoffmann and Lord Millett in *Buchler v Talbot* [2004] UKHL 9; [2004] 2 AC 298, at [29] and [51], respectively.

⁸¹⁷ The comparable section for bankruptcy is s 340 of the Insolvency Act 1986.

⁸¹⁸ The powers of the court to make an order are discussed below.

⁸¹⁹ See 14.16.3.1

⁸²⁰ S 240(1)(a) of the Act. The test for connection is contained in s 249 of the Act.

⁸²¹ S 240(1)(b) of the Act.

⁸²² S 240(1)(c) and (d) of the Act.

will only be a relevant time in either of the first two situations if the company was insolvent (i.e. unable to pay its debts within the meaning of section 123 of the Insolvency Act 1986) at the time the preference was given, or became insolvent in consequence of the giving of the preference.⁸²³

*14.16.4.3 A preference*⁸²⁴

A company gives a preference in favour of another person if:

- (a) that other person is one of the company's creditors or a guarantor or surety of any of the company's debts or other liabilities, and
- (b) the company does anything or suffers anything to be done which (in either case) has the effect of putting that person in a better position than he would otherwise have endured in an insolvent liquidation of the company.

14.16.4.3.1 It is a question of fact as to whether or not the relevant person has been put in a better position than it was in before the relevant act was done. It follows that there cannot be a preference in favour of someone who was not an existing creditor, guarantor, or surety. Hence, the granting of security to a new lender will not amount to a preference. In addition, on the basis that it would not put the lender in a better position than it was in beforehand, the granting of security simply to cover a new facility that is made available by an existing lender should also be safe, so long as the facility does not amount to a re-financing of existing indebtedness and the security does not extend to cover the existing indebtedness.

14.16.4.3.2 Examples where a person would be put in a preferential position would include repayment of existing indebtedness of the company, the granting of security for existing indebtedness⁸²⁵, repaying a creditor so as to relieve a guarantor of exposure under the guarantee, and any other act which has the effect of putting an existing creditor in a better position than it would be in should the company go into insolvent liquidation.

14.16.4.3.3 The fact that the act was done pursuant to a court order does not prevent it from being a preference.⁸²⁶

*14.16.4.4 Influenced by a desire*⁸²⁷

The court may only make an order if the company, in giving the preference, was 'influenced by a desire' to achieve the result mentioned in (b) above (i.e. to put the other person in that better position). This will be presumed (unless the contrary is proved) where the other person was connected with the company.⁸²⁸ It is the decision to give a preference, rather than the giving of the preference pursuant to that decision, which must be influenced by the desire to produce the effect⁸²⁹ although the decision to give preference may coincide with the act that has the effect of preference.⁸³⁰

⁸²³ S 240(2) of the Act.

⁸²⁴ S 239(4) of the Act.

⁸²⁵ See David Richards J in *Green (Liquidator of Stealth Construction Ltd) v Ireland* [2011] EWHC 1305 (Ch) at [61].

⁸²⁶ S 239(7) of the Act.

⁸²⁷ S 239(5) of the Act.

⁸²⁸ S 239(6) of the Act.

⁸²⁹ See David Richards J in *Green (Liquidator of Stealth Construction Ltd) v Ireland* [2011] EWHC 1305 (Ch) at [56].

⁸³⁰ *Wills v Corfe Joinery Ltd* [1997] BCC 511.

Hence, the relevant date is the date of the decision to give preference, not the date when the preference is given.⁸³¹ The question of when the decision is made is a question of fact to be determined in the particular circumstance of each case; a mere existence of a contractual obligation to do a particular act (which has the effect of preference) is neither necessary nor of itself sufficient.⁸³² There must probably have been some contemplation that the company may not be able to pay its debts. It is the subjective desire of the company which is relevant, not that of the recipient of the preference, although it might be possible to infer the desire from the relevant circumstances.⁸³³ Because the company must have been influenced by the desire, there must be a positive desire to prefer, although it need not be the only or predominant intention of the company; it can be one of the factors that influenced the company.⁸³⁴ A decision that is taken for proper commercial considerations should be contrasted with one that was intended to put the other party in a preferred position.⁸³⁵ An intention to keep the support of the company's bank by giving it security may not amount to a desire to prefer the bank.⁸³⁶

14.16.5 Sections 238 and 239: remedies

Each of sections 238 and 239 of the Act provides that the court may make such order as it thinks fit to restore the position to what it would have been but for the impugned transaction or giving of the preference. Section 241 of the Act⁸³⁷ amplifies upon this by setting out a non-exhaustive list of the orders that the court may make. The remedies available under sections 238 and 239 are without prejudice to any other remedies that might be available at general law.⁸³⁸

14.16.5.1 It is clear that the power of the court is discretionary and that the court is given a wide discretion as to the orders that it might make, although the court should not act oppressively or unreasonably.⁸³⁹ The court should take into account whether it would be appropriate to make an order that would have extra-territorial effect.⁸⁴⁰ It has been held that the circumstances may justify the court in making no order at all.⁸⁴¹

14.16.5.2 The court might order monetary compensation or a reversal of the transaction and appropriate compensatory adjustments for any compensation that had been received.⁸⁴² In relation to a transaction or preference which had the effect of

⁸³¹ See Millet J in *Re MC Bacon Ltd* [1990] BCC 78, at 88, see also Mummery J in *Re Fairway Magazines Ltd* [1992] BCC 924.

⁸³² See David Richards J in *Green (Liquidator of Stealth Construction Ltd) v Ireland* [2011] EWHC 1305 (Ch), [2012] 1 BCLC 297 [63].

⁸³³ *Re Fairway Magazines Ltd* [1992] BCC 924. For example, a preference claim was not made out where a director of a company was not shown to be "influenced" by a desire to avoid paying another's claim in circumstances in which he had a genuinely held belief that another's claim had no merit, even though objectively it was possible to conclude otherwise, see *Green v El Tai* [2015] BPIR 24, paras [86], [99]-[101] (Registrar Jones).

⁸³⁴ *Re MC Bacon Ltd* [1990] BCC 78.

⁸³⁵ *Re Fairway Magazines Ltd* [1992] BCC 924.

⁸³⁶ *Re MC Bacon Ltd* [1990] BCC 78.

⁸³⁷ The comparable section for bankruptcy is s 342 of the Insolvency Act 1986.

⁸³⁸ S 241(4) of the Act.

⁸³⁹ See Sir Donald Nicholls V-C in *Re Paramount Airways Ltd* [1993] Ch 223, at 239.

⁸⁴⁰ *Re Paramount Airways Ltd* [1993] Ch 223; *Re Unigreg Ltd* (unreported, 12/2/2004, Judge Weeks QC sitting in the High Court).

⁸⁴¹ *Singla (Trustee of Brown) v Brown and Malden-Browne* [2007] EWHC 405 (Ch), [2007] BPIR 424.

⁸⁴² *Re Thoars (Decd), Ramlort Ltd v Reid* [2004] EWCA Civ 800, [2004] BPIR 985.

releasing or discharging a surety, the court is specifically given the power to reinstate the surety's obligations.⁸⁴³

14.16.5.3 Third parties

Section 241(2) of the Act provides that the order that the court makes may affect a third party or property of a third party, even if the third party was not the direct party to an impugned transaction or the direct recipient of a preference. It goes on, however, to provide a defence to a third party with a derivative, rather than direct, connection with an impugned transaction or preference, if it acted in good faith and for value. The onus is on the defendant to make out the defence.⁸⁴⁴ There are several further factors which must be taken into account in relation to such a defence.⁸⁴⁵

14.16.5.4 Secured parties

The question arises as to whether the recovery that a liquidator or administrator might make under section 238 or section 239 would be subject to security that had been given by the company prior to the onset of the insolvency proceedings. At the outset, the question must be distinguished from the position where property which is the subject of proceedings brought by the insolvency official was disposed of by the debtor company at a time when it was within the compass of fixed security and such disposition was without the security holder's consent. In such a case, the property might continue to be the subject of the security, on the basis as discussed earlier in this chapter. In such a case, the proceedings brought by the insolvency official should not overreach the security holder's interest under its pre-existing security. On the other hand, if the property was only subject to an uncrystallised floating charge at the time of its disposition, and the disposition was by way of absolute transfer, then it would have ceased to be subject to the charge at the time of the disposition, provided the disposition fell within the broadly understood concept of being in the ordinary course of business.

14.16.5.4.1 Bearing those points in mind, the question might become whether the benefit of the recovery by the liquidator or administrator in proceedings brought under the sections would fall within the compass of pre-existing security where the security contains an after-acquired property clause which, in its terms, seeks to catch such benefit. Generally speaking, the answer to the question should be that the benefit of the recovery by the insolvency official would not be caught by the pre-existing security, particularly where the recovery is seen as being compensatory, such as where the defendant is required to make a payment to redress any unfair benefit it had received under the impugned transaction. This is because the right of action is vested in the insolvency official. The proceedings are brought by him for the benefit of the general body of unsecured creditors. The recoveries are held by the insolvency official for the benefit of the general body of creditors,⁸⁴⁶ which should be seen as

⁸⁴³ S 241(1)(e) of the Act.

⁸⁴⁴ *Re Sonatacus Ltd* [2007] EWCA Civ 31, [2007] BCC 342. The court can only properly exercise its discretion against a third party if the order is required to restore the company's position to what it would otherwise have been, and the third party is in possession of assets or, at least, had otherwise personally benefited in monetary terms from the payment in some direct and tangible way, see Mark Cows QC *obiter* in *Re Oxford Pharmaceuticals Ltd (sub nom Wilson v Masters International Ltd)* [2009] EWHC 1753, [2009] 2 BCLC 485 at [83]-[90].

⁸⁴⁵ See ss 241(2A) to (3C) of the Act.

⁸⁴⁶ *Re Yagerphone Ltd* [1935] 1 Ch 392; *Re MC Bacon Ltd* [1991] Ch 127, at 137.

being distinct from the property rights of the company prior to the onset of the insolvency proceedings.

14.16.5.4.2 Some qualification may have to be made to that analysis, however. As mentioned above, it has been held that, amongst the armoury of orders that are available, the court might require that a previous transfer of property by the debtor should be reversed, so that the property is re-vested in the debtor. This is recognised by section 241(1)(a) of the Act, which includes amongst the orders that the court may make, an order that any property which the company had transferred should be vested in the company. In such a case, it might be arguable that the effect of the vesting in the company is that its property is restored to it *in specie*, so that it resumes its ownership of the property as if the impugned transaction had not taken place.⁸⁴⁷ Alternatively, it might be argued that the vesting has the effect of conferring a property right on the company. Thus, the vesting might be seen either as restoring the situation to that which existed before the impugned original transfer by the company, so that the asset would be subject to the security that had then existed, or the vesting might be seen as having the effect of conferring a property right on the company which would then fall under the after-acquired property clause in the security. However, those arguments must still be viewed in light of the fact that the order of the court re-vesting the property only occurs in consequence of the pursuit of a right of action that is settled on the insolvency official for the benefit of the general body of the debtor's creditors. The right is not exercisable by or for the benefit of the security holder. In policy terms, it is difficult to see how it would be correct to finish up with the result that the outcome of the proceedings should benefit the security holder.

14.16.6 Transactions defrauding creditors

Section 423 of the Act concerns transactions at an undervalue that a debtor has entered into to defraud or prejudice one or more of its creditors. That section is supported by further provisions in sections 424 and 425 of the Act. Section 423 applies to both company debtors and individual debtors and it applies whether or not insolvency proceedings have been commenced against the debtor. There is no necessity to show that the debtor was insolvent at the time of the relevant transaction and there are no time limits in terms of when the transaction took place.⁸⁴⁸ The court has a wide discretion in the orders it may make to restore the position to what it would have been had the transaction not occurred and to protect the interests of persons who were victims of the transaction. This is amplified in section 425 of the Act, which also provides for certain defences that are available to third parties.

14.16.6.1 The ingredients of the section are that there should have been (i) a transaction at an undervalue that was entered into by the debtor, (ii) which was entered into for a relevant purpose, and (iii) which has been to the actual or potential prejudice of one or more victims, by whom or on whose behalf a claim is brought under the section. Those ingredients will now be examined.

⁸⁴⁷ See *NA Kratzmann Pty Ltd v Tucker* (1968) 123 CLR 295 for a similar view that has been taken in Australia.

⁸⁴⁸ Although the Limitation Act 1980 will apply: see *Hill (as Trustee in Bankruptcy of Nurkowski) v Spread Trustee Co Ltd* [2006] EWCA Civ 542, [2006] BCC 646; *Giles v Rhind* [2008] EWCA Civ 118.

14.16.6.2 Transaction at an undervalue

The expression ‘transaction at an undervalue’ as used in section 423 of the Act is, essentially, the same as that used in section 238 of the Act, with the additional ground of a transaction that was entered into in consideration of marriage or a civil partnership.⁸⁴⁹

14.16.6.3 Purpose

Section 423(3) of the Act provides that the court may only make an order if the court is satisfied that the purpose of the debtor in entering into the transaction at an undervalue was either:

- (a) to put assets beyond the reach of a person who is making, or may at some time make, a claim against the debtor, or
- (b) otherwise to prejudice the interests of such a person in relation to the claim which he is making or may make.

14.16.6.3.1 The purpose must have been a real or substantial purpose but it need not be the only or dominant purpose for the transaction.⁸⁵⁰ Arden LJ made a number of further comments as to the concept of purpose as it is relevant to section 423 in *Hill (as Trustee in Bankruptcy of Nurkowski) v Spread Trustee Co Ltd*.⁸⁵¹ Her Ladyship said that it was not necessary to show that the purpose of the debtor could be achieved by entering into the transaction. Similarly, the debtor might have the necessary purpose even though he was mistaken in believing that he could achieve that purpose by entering into the transaction. It was the entry into the transaction, not the outcome of the transaction itself, which must have the necessary purpose. The concept of purpose would not be satisfied by evidence that the debtor only had a mere hope, but it would be sufficient to show a positive intention, which substantially motivated the debtor in entering into the transaction.

14.16.6.4 Victims

Proceedings under section 423 might be instituted by either an insolvency official or a ‘victim’ of the transaction.⁸⁵² Such proceedings are brought on behalf of all of the victims of a transaction,⁸⁵³ although it is still possible for proceedings to be brought if there is only one victim, such as where its security has been adversely affected by the transaction.⁸⁵⁴ In a situation where the insolvency officer declines to bring proceedings to set the transaction aside, a victim of the transaction may apply to the court but must demonstrate that he has a realistic prospect of establishing, first, that the transaction in question comes within the scope of section 423 and that he is a victim of the transaction and, second, that there is good reason why he should bring the proceedings even though the liquidator or administrator does not.⁸⁵⁵

⁸⁴⁹ S 423(1) of the Act.

⁸⁵⁰ *Inland Revenue Commissioners v Hashmi* [2002] EWCA Civ 981, [2002] BCC 943.

⁸⁵¹ [2006] EWCA Civ 542; [2006] BCC 646, at [102].

⁸⁵² This is subject to s 424(1) of the Act in a case where the debtor is subject to insolvency proceedings.

⁸⁵³ S 424(2) of the Act.

⁸⁵⁴ *National Westminster Bank PLC v Jones* [2001] EWCA Civ 1541, [2002] 1 BCLC 55.

⁸⁵⁵ See Sir Christopher Slade in *National Bank of Kuwait SAK v Menzies* [1994] BCC 119 (CA) at 125 and Sir William Blackburne in *Re Simon Carves Ltd; Carillion Construction Ltd v Hussain* [2013] EWHC 685 (Ch), [2013] 2 BCLC 100 [25]-[27].

A victim of the transaction is a person who is, or is capable of being, prejudiced by it.⁸⁵⁶ It is a wider category than simply creditors.⁸⁵⁷ A person may be a victim of a transaction, and thus a person whose interests may be protected by an order under section 423(5), even though the debtor's purpose in entering into the transaction, as referred to in section 423(3), may not have been to prejudice that person but, rather, someone else; indeed the debtor may have been unaware of the victim when the transaction was entered into.⁸⁵⁸

14.16.7 Avoidance of floating charges

Section 245 of the Act applies to floating charges.⁸⁵⁹ It gives the liquidator or administrator of a debtor company the right to challenge (in whole or in part) a floating charge that was given by the company, if the charge was created at a 'relevant time' prior to the onset of the relevant insolvency proceedings. It should be noted, at the outset, that section 245 of the Act does not apply to a floating charge which is within a security financial collateral arrangement, as discussed earlier in this chapter.⁸⁶⁰

14.16.7.1 Relevant time

There are three alternative periods in which a 'relevant time' might have occurred in relation to the granting of the charge.⁸⁶¹ Where the charge was created in favour of a person that is connected to the company,⁸⁶² a relevant time can be any time within a period of two years prior to the onset of the insolvency proceedings.⁸⁶³ Where the chargee was not a connected person, a relevant time can be any time within a period of one year before the onset of the insolvency proceedings, provided that the debtor company was either then insolvent or it became insolvent in consequence of the transaction under which the charge was created. Whether or not the chargee was connected to the company, a charge will also be created at a relevant time if it was created in the preliminary period before an administrator was appointed.

14.16.7.2 The invalidity⁸⁶⁴

If the floating charge was created at a relevant time then it is invalid except to the extent of:

- (a) the value of so much of the consideration for the creation of the charge as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge,
- (b) the value of so much of that consideration as consists of the discharge or reduction, at the same time as, or after, the creation of the charge, of any debt of the company, and
- (c) interest thereon..

⁸⁵⁶ S 423(5) of the Act.

⁸⁵⁷ *Clydesdale Financial Services Ltd v Smailes* [2009] EWHC 3190, [2011] 2 BCLC 405 [69]-[74].

⁸⁵⁸ See Arden LJ in *Hill (as Trustee in Bankruptcy of Nurkowski) v Spread Trustee Co Ltd* [2006] EWCA Civ 542; [2006] BCC 646, at [101].

⁸⁵⁹ I.e. a charge which was created as a floating charge, even if it has crystallised: see s 251 of the Act.

⁸⁶⁰ See Reg 10(5) of the Financial Collateral Arrangements (No 2) Regs 2003 (SI 2003/3226).

⁸⁶¹ Ss 245(3) and (4) of the Act.

⁸⁶² The test for connection is contained in s 249 of the Act.

⁸⁶³ As defined in s 245(5) of the Act.

⁸⁶⁴ S 245(2) of the Act.

14.16.7.3 Points arising

Unlike the position under section 239 of the Act, there is no need for the insolvency official to prove any intention to prefer the interests of the chargee. In other words, to the extent that the charge secures a pre-existing liability of the chargor to the chargee, the charge is invalid. Nor can the charge be saved by a defence like that which is provided in section 238(5) for transactions at an undervalue (i.e. bona fide intention and reasonable belief of benefit to the company). On the other hand, the charge is only invalid under the section to the extent that it secures such pre-existing indebtedness; it is not invalid under section 245 with respect to any value provided at the same time as, or after, its creation.

14.16.7.3.1 Cases decided under predecessor legislation had taken a liberal view as to the saving condition that the secured value should have been contemporaneous or subsequent to the granting of the charge. It had been held that the requirement would be taken as met, even if the value was provided before the charge was created, provided that the value was provided in consideration of an agreement that the charge would be provided.⁸⁶⁵ That view no longer applies. The requirement is now that the charge should truly be contemporaneous with, or precede, the giving of value by the chargee, although it might be permissible to save a later formal security document which merely implements a preceding, but enforceable, charge.⁸⁶⁶

14.16.7.3.2 The value of goods or services supplied is their monetary value at the time of supply to the company, taken as the amount which could reasonably have been obtained for their supply in the ordinary course of business on the same terms.⁸⁶⁷ It should be noted that the money or the goods and services must be paid or supplied to the company, hence a charge to secure an advance to a third party would not be saved. However, it is legitimate for the charge to secure a payment made to a third party on behalf of the company, if the company was indebted to the third party, as that would be done in discharge of the indebtedness of the company to the third party.

14.16.7.3.3 The charge can legitimately cover money lent for a re-financing or discharge of existing indebtedness of the company. It is submitted, however, that this must be the re-financing or discharge of indebtedness due to a third party and not to the lender itself, as that would not constitute the provision of new value to the company.⁸⁶⁸

14.16.7.3.4 The effect of the section is to avoid the charge, not any debt obligation purportedly secured under it, so that the section cannot be relied upon to challenge a repayment of the debt.⁸⁶⁹

14.16.7.3.5 Section 245 represents a rare situation where the rule in *Clayton's case*⁸⁷⁰ may be applied for the advantage of a bank.⁸⁷¹ By the application of the rule, indebtedness on a running account that was existing at the time the charge was taken can be treated as discharged by payments that are made into the account, whereas drawings from the account after the charge was taken are treated as effectively

⁸⁶⁵ *Re Columbian Fireproofing Co Ltd* [1910] 1 Ch 758.

⁸⁶⁶ *Re Shoe Lace Ltd, Power v Sharp Investments Ltd* [1993] BCC 609.

⁸⁶⁷ S 245(6) of the Act.

⁸⁶⁸ See *Re GT Whyte & Co Ltd* [1983] BCLC 311.

⁸⁶⁹ *Mace Builders (Glasgow) Ltd v Lunn* [1987] Ch 191.

⁸⁷⁰ *Devaynes v Noble, Clayton's Case* (1816) LJ Ch 256, 35 ER 767.

⁸⁷¹ See *Re Yeovil Glove Co Ltd* [1965] Ch 148.

secured under the charge and will not be treated as paid off until all of the old debt has been repaid.

14.16.8 Extortionate credit transactions

Section 244 of the Act⁸⁷² concerns extortionate credit transactions. It gives a liquidator or administrator the power to challenge such a transaction (whether it remains current or has terminated) if it was entered into by the debtor company within a period of three years preceding the onset of the relevant insolvency proceedings.⁸⁷³ The court is given a number of wide powers to re-order or otherwise qualify the transaction, an obligation under it or any relevant security, or to require payments to be made to the insolvency official or for accounts to be taken.⁸⁷⁴ The burden is on the person defending the transaction to show that it was not extortionate.⁸⁷⁵ Because of the language that it used, it is submitted that the court could re-open a transaction and review the effect of the transaction with reference to the position at the outset of the transaction or with respect to the effect of changes in an interest rate or other matters which came into effect or occurred after the date on which the transaction took effect.⁸⁷⁶

14.16.8.1 Section 244(3) provides that:

. . . a transaction is extortionate if, having regard to the risk accepted by the person providing the credit—

- (a) the terms of it are or were such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of credit, or
- (b) it otherwise grossly contravened ordinary principles of fair dealing.

14.16.8.2 The concept of an extortionate credit transaction was considered by the Court of Appeal in *Paragon Finance plc v Staunton*.⁸⁷⁷ That was a case which concerned comparable provisions in what was then sections 137 and 138 of the Consumer Credit Act 1974 (now repealed). The court quoted from Professor Sir Roy Goode's book, *Consumer Law and Practice*,⁸⁷⁸ that:

the concepts of extortion and unconscionability are very similar. 'Extortionate', like 'harsh and unconscionable', signifies not merely that the terms of the bargain are stiff, or even unreasonable, but that they are so unfair as to be oppressive. This carries with it the notion of morally reprehensible conduct on the part of the creditor in taking grossly unfair advantage of the debtor's circumstances.⁸⁷⁹

⁸⁷² The comparable provision for individuals will be found in s 343 of the Act.

⁸⁷³ S 244(2) of the Act. A challenge to a transaction may be mounted under this section concurrently with a challenge under s 238 of the Act: see s 244(5) of the Act.

⁸⁷⁴ S 244(4) of the Act.

⁸⁷⁵ S 244(3) of the Act.

⁸⁷⁶ This is different from the position under comparable provisions that used to apply under ss 137 and 138 of the Consumer Credit Act 1974 (now repealed), where the position had to be judged primarily as at the time the transaction was entered into: see *Paragon Finance plc v Staunton* [2001] EWCA Civ 1466; [2002] 1 WLR 685, at [63]–[66]; *Broadwick Financial Services Ltd v Spencer* [2002] EWCA Civ 35; [2002] 1 All ER (Comm) 446, at [48]–[56].

⁸⁷⁷ [2001] EWCA Civ 1466, [2002] 1 WLR 685.

⁸⁷⁸ At para 47.26.

⁸⁷⁹ See also Sir John Donaldson MR in *Wills v Wood* [1984] CCLR 7.

14.17 Enforcement of Security

14.17.1 Determining whether to enforce and the position before enforcement

The rights and duties of a secured creditor in relation to the enforcement of its security are grounded in equity. Assuming that the right to enforce has arisen due to the default of the obligor,⁸⁸⁰ the creditor is then entitled to determine in its own interests when and how it wishes to enforce its security, and, if the security involves more than one item of property, the order in which it will enforce its security over those items of property.⁸⁸¹ The security holder is under no obligation to preserve the security prior to the exercise of its enforcement rights.⁸⁸² If the obligor is unhappy with the situation and the delay in the enforcement of the security, it can either exercise its right of redemption, pay off the outstanding liability, and retrieve the security, or it can apply to the court for an order for sale of the property.⁸⁸³ The obligor's right of redemption was mentioned earlier in this chapter.

14.17.1.1 There are statutory limitations upon the right of enforcement of security where the obligor is in administration⁸⁸⁴ or, if it is an eligible company, where proposals have been made for a voluntary arrangement concerning it.⁸⁸⁵

14.17.1.2 Prior to the right to enforcement arising, generally speaking the security holder does not have rights to intervene in relation to the secured property, unless it can show that the sufficiency of its security was threatened. However, there is no legal restriction on the security holder from doing so if it is given the appropriate power by the security instrument. Accordingly, it would be entitled to require that an option should be exercised if the benefit of the option formed part of the security. It would be a matter of interpretation to see if the parties had agreed that the security holder should have such a right.⁸⁸⁶

14.17.1.3 Where the security holder's consent was required before the obligor could take certain action with respect to the secured property prior to the enforcement of the security then, in the absence of a contractual provision to the contrary, the security holder is entitled to have regard to its own interests, rather than those of the obligor, in deciding if it should grant its consent.⁸⁸⁷ Yet the courts have shown some sympathy, in the context of a requirement of consent to letting in land mortgages, for a qualification to such requirement that consent is not to be unreasonably withheld, although a separate covenant not to withhold consent unreasonably (giving rise to a

⁸⁸⁰ For instance, by the obligor failing to meet a lawful demand for repayment: *Bank of Baroda v Panessar* [1987] Ch 335. See further Chap 3.

⁸⁸¹ *Farrar v Farrars Ltd* (1888) 40 LR 40 ChD 395; *China and South Sea Bank Ltd v Tan* [1990] 1 AC 536.

⁸⁸² *AIB Finance Ltd v Alsop (Debtors)* [1998] 2 All ER 929.

⁸⁸³ S 91 of the Law of Property Act 1925. See *Palk v Mortgage Services Funding PLC* [1993] Ch 330.

⁸⁸⁴ See para 43(2) of Sched B1 to the Insolvency Act 1986 (which is extended to the period preliminary to the appointment of the administrator by para 44 of that Schedule).

⁸⁸⁵ See para 12(1)(g) of Sched A1 to the Insolvency Act 1986. There are also limits under consumer protection legislation, where the security giver is an individual.

⁸⁸⁶ See *Citibank NA v MBIA Assurance SA* [2007] EWCA Civ 11, [2007] 1 All ER (Comm) 475, which followed *Wise v Landsell* [1921] 1 Ch 420 and *Nelson v Hannam* [1943] 1 Ch 59.

⁸⁸⁷ *Starling v Lloyds TSB Bank PLC* [2000] Lloyd's Rep Bank 8.

right to damages) would not be implied.⁸⁸⁸ This position was confirmed in *Commercial First Business Ltd v Atkins*,⁸⁸⁹ where the judge made a more detailed analysis of the position.⁸⁹⁰ A mortgagee is entitled to require consent to letting for its own protection and, while it must not refuse that consent on grounds which have nothing to do with the mortgage, and there may be exceptional cases where there is such a disproportion between the benefit to the mortgagee and the detriment to the mortgagor if the mortgagee were to withhold his consent to a proposed letting, that it would be unreasonable for the mortgagee to refuse such consent, generally the mortgagee is free to consider its own interests and to justify the reasonableness of its decision on objective grounds. It is for the mortgagor to prove that consent was unreasonably withheld. This analysis mirrors the statutorily qualified requirement of consent to letting under the Landlord and Tenant Act section 19(1) and, in modified form, the analysis of the qualification of reasonableness in *International Drilling Fluids Ltd v Louisville Investments (Uxbridge) Ltd*.⁸⁹¹ This approach is an attempt to balance the interests of both parties, while not imposing a free-standing covenant on the mortgagee; parties are, of course, free to expressly agree otherwise.

14.17.1.4 The methods of enforcement that exist under English law, at least in theory, are foreclosure, the application of financial collateral under a security financial collateral arrangement, and the application of cash balances, taking possession of the secured property, the exercise of a power of sale, the appointment of an administrator, and the appointment of a receiver. Each of those methods of enforcement will now be looked at in turn.

14.17.2 Foreclosure

14.17.2.1 Foreclosure is the most ancient of the powers of enforcement, although it rarely arises and so it is more of a theoretical than real power of enforcement. It is the method by which the obligor's equity or redemption is closed out or, in effect, extinguished, so that the creditor becomes the full and unencumbered owner of the property.⁸⁹² Once the foreclosure has been completed, the creditor loses its right to pursue the obligor for the debt that was secured on the property, unless it gives up its rights and allows the foreclosure to be re-opened, which the security holder cannot do if it has sold the property.⁸⁹³ Foreclosure is only available where the security is a legal mortgage⁸⁹⁴ or an equitable mortgage which can be perfected by being turned into a legal mortgage pursuant to an agreement by the mortgagor to give a legal mortgage.⁸⁹⁵

⁸⁸⁸ See *Citibank International Plc v Kessler* [1999] Lloyds's Law Reports Banking 123, 129; *Starling v Lloyds TSB Bank PLC* [2001] EGLR 101,104.

⁸⁸⁹ [2012] EWHC 4388 (Ch).

⁸⁹⁰ At [107].

⁸⁹¹ [1986] 1 Ch 513, 519–521. There have been a number of recent cases considering reasonableness of consent in different contexts, for example (in the context of consent to assignment of a syndicated loan) see *Barclays Bank plc v Unicredit Bank AG* [2014] EWCA Civ 302; *BG Global Energy Limited v Talisman Sinopec Energy UK Limited* [2015] EWHC 110 (Comm) [109].

⁸⁹² See *Silberschildt v Schiott* (1814) 3 Ves&B 45; *Le Gros v Cockerell* (1832) 5 Sim 384; *Carter v Wake* (1877) 4 ChD 605; and *Re Farnol Eades Ervine & Co* [1915] 1 Ch 22.

⁸⁹³ *Lockhart v Hardy* (1846) 9 Beav 349.

⁸⁹⁴ *General Credit and Discount Co v Glegg* (1883) 22 ChD 549.

⁸⁹⁵ *Perry v Keane, Perry v Partridge* (1836) 6LJCh 67; *Cox v Toole* (1855) 20 Beav 145.

It is not available to enforce a pledge of goods,⁸⁹⁶ nor to enforce an equitable charge or an equitable mortgage which cannot be turned into a legal mortgage.⁸⁹⁷

Foreclosure requires an order of the court which extinguishes the obligor's equity of redemption, which will not be given without allowing the obligor time to pay, failing which the order will be made absolute and the equity of redemption will be extinguished.⁸⁹⁸ The court can order the property to be sold in any foreclosure action,⁸⁹⁹ which is what it would normally do. Given these formalities, the remedy of foreclosure is not attractive to secured creditors and is rarely used.

14.17.3 Application of financial collateral

A legal or equitable mortgagee of financial collateral under a security financial collateral arrangement may appropriate the collateral by way of enforcement, if the security instrument permits it to do so. This has been discussed earlier in this chapter.

14.17.4 Application of cash balances

Where security has been taken over the benefit of a bank account, that is, the cash balance on the account, then if the cash balance comprises financial collateral under a security financial collateral arrangement, and that arrangement is by way of legal or equitable mortgage, it should be possible to appropriate it by the method just referred to (provided that the security instrument permits such action). In the alternative, the appropriation could be effected at common law. This method of enforcement was acknowledged by Lord Hoffmann in *Re Bank of Credit and Commerce International SA (No 8)*,⁹⁰⁰ which was a case where the cash balance arose on an account that was held with the security taker. Of course, when cash is appropriated there is no need to value the collateral,⁹⁰¹ so appropriation is very straightforward and takes place by book entry.

14.17.4.1 It is submitted that where the bank account over which security has been taken is held with a third party, the security would be enforced by requiring the third party to pay the balance in the account to the security taker, which would then effect the application as the final step in the enforcement, repaying any surplus to the security provider. The same analysis should also apply in the case of any other debt that is the subject of security, where the security holder obtains payment of it and then applies that payment in satisfaction of the secured liability.

14.17.5 Taking possession

The right to take possession is usually associated with a mortgage of land, by which the mortgagee becomes entitled to collect the rents on the property. It also applies to other types of property, although the right to take possession of goods under a security bill of sale given by an individual is restricted.⁹⁰² For instance, the right to take possession of the mortgagor's business has been permitted where the security

⁸⁹⁶ *Carter v Wake* (1877) 4 ChD 605.

⁸⁹⁷ *Tenant v Trenchard* (1869) 4 Ch App 537; *Re Owen* [1894] 3 Ch 220.

⁸⁹⁸ *Platt v Mendel* (1884) 27 ChD 246.

⁸⁹⁹ S 91(2) of the Law of Property Act 1925.

⁹⁰⁰ [1998] AC 214.

⁹⁰¹ See 14.7.6.4.

⁹⁰² See s 7 of the Bills of Sale Act (1878) Amendment Act 1882.

extended to the business.⁹⁰³ At common law, the right to take possession by implication of the security only arises if the security is by way of legal mortgage. It does not extend to equitable mortgages or charges.⁹⁰⁴ This problem is often overcome by an express provision in the security instrument. Possession may not be taken of a dwelling house without a court order.⁹⁰⁵

14.17.5.1 A security holder which goes into possession undertakes onerous duties with respect to the secured property and, for that reason, it is generally considered best not to go into possession. By going into possession, the security holder assumes a duty to take reasonable care of the property and to protect and exploit it, maximising the return but without taking undue risks.⁹⁰⁶ For example, the security holder has a duty, albeit limited,⁹⁰⁷ to execute repairs to real property and is liable for waste, that is, destruction or damage to the property.⁹⁰⁸ The security holder is liable to account for both the income it receives from the property whilst in possession as well as what it would have received but for its wilful default or negligence in failing to exploit the property.⁹⁰⁹ A security holder in possession of land may find itself responsible for environmental liabilities.

14.17.6 The power of sale

When examining the right of a security holder to sell the secured assets by the exercise of its power of sale, a distinction needs to be drawn between the right of a pledgee to sell the goods that are subject to the pledge, and the position as it relates to non-possessory security.

14.17.6.1 Pledges

A pledgee, who, of course, has possession already, has a power of sale at common law which is an inherent incident of the security.⁹¹⁰ The duties as to the exercise of the power are pretty much the same as those that apply to a sale under non-possessory security.⁹¹¹

14.17.6.2 Non-possessory security

The position at common law as to an implied power of sale under non-possessory security was not very satisfactory.⁹¹² To overcome those difficulties, it became common to include an express power of sale and to take a power of attorney from the security giver, so that an equitable security holder could convey the legal title.⁹¹³ The

⁹⁰³ *Chaplin v Young* (1863) 33 Beav 330.

⁹⁰⁴ *Western Bank Ltd v Schindler* [1977] Ch 1.

⁹⁰⁵ S 36 of the Administration of Justice Act 1970.

⁹⁰⁶ *Silven Properties Ltd v Royal Bank of Scotland PLC* [2003] EWCA 1409, [2004] 1 WLR 997.

⁹⁰⁷ *Perry v Walker* (1855) 3 Eq Rep 721; *Silven Properties Ltd v Royal Bank of Scotland PLC* [2003] EWCA 1409, [2004] 1 WLR 997.

⁹⁰⁸ *Millett v Davey* (1862) 9 Jur NS 92.

⁹⁰⁹ *Chaplin v Young* (1863) 33 Beav 330; Rigby LJ in *Gosling v Gaskell* [1896] 1 QB 669, at 691 (approved on appeal at [1897] AC 575).

⁹¹⁰ *Pothonier & Hodgson v Dawson* (1816) Holt 383; Cotton LJ in *Re Morritt, ex p Official Receiver* (1886) 18 QBD 222, at 232.

⁹¹¹ See the Privy Council in *The Odessa* [1916] 1 AC 145, at 159.

⁹¹² The power did not exist for a legal mortgage of land, because of the right to apply for an order for foreclosure. It did exist in relation to mortgages of personal chattels: see Cotton LJ in *Re Morritt, ex p Official Receiver* (1886) 18 QBD 222, at 233.

⁹¹³ It remains possible to take an express power of sale: *The Maule* [1997] 1 WLR 528.

position is now dealt with by statute. Section 101(1)(i) of the Law of Property Act 1925 provides for an implied power of sale of any secured property⁹¹⁴ under any mortgage or charge⁹¹⁵ which has been made by deed. The right to exercise the implied power is regulated by section 103 of the Act, but this is usually overcome by express wording, as permitted by section 101(3) of the Act. It is also possible to apply to the court for an order for sale under section 91 of the Act.

14.17.6.2.1 The effect of the exercise of the statutory power of sale is provided for in section 104 of the Act. In effect, the sale overreaches any interests that were subordinate to those of the security holder which has exercised the power of sale, but the sale will be subject to interests which had priority over the interest of that security holder. However, if at the time of sale the security holder's power of sale has not arisen, its effect will be only to assign the security holder's own interest.⁹¹⁶ Section 105 provides for the disposition of the proceeds of the sale.

14.17.6.3 Duties in exercising the power of sale

The security holder in exercising its power of sale is subject to important equitable duties.⁹¹⁷ The duties are owed to the security giver and others interested in the equity of redemption, such as other security holders of the property and, guarantors.⁹¹⁸ The first is the duty to act in good faith so as not deliberately to set out to injure the mortgagor.⁹¹⁹ The second duty is to obtain a proper price, being the fair or true market value of the property at the time of sale.⁹²⁰ In meeting that duty, the security holder must take proper care, such as by fairly and properly advertising the property, to obtain the best price reasonably obtainable at the date of the sale. Accordingly, the security holder may not act in a way which unfairly prejudices the security giver by selling hastily at a knock-down price.⁹²¹ On the other hand, the security holder is entitled to accept a firm offer to purchase, rather than having to wait so as to see if a higher, but uncertain, offer will materialise.⁹²² The security holder is entitled to sell the property in its existing state and, accordingly, there is no duty to improve the property or take other action to make it more saleable.⁹²³ The security holder is obliged to ensure that any extra potential improvement that might be available for increasing the value of the property is properly advertised so as to influence the sale price, but the security holder is not obliged to undertake action to make the improvement.⁹²⁴ If the security giver wishes to obtain greater protection than the

⁹¹⁴ See the definition of 'mortgage' and 'property' in ss 205(1)(xvi) and (xx) of the Act.

⁹¹⁵ A 'mortgage' is defined to include a charge: see s 205(1)(xvi) of the Act. A similar construction applies to the expression 'mortgagee'.

⁹¹⁶ *Cherry Tree Investments Ltd v Landmain Ltd* [2012] EWCA Civ 736, [2013] Ch 305.

⁹¹⁷ The duties are equitable rather than arising at common law: *China and South Sea Bank Ltd v Tan* [1990] 1 AC 536. The duties are comprehensively summarised in *Silven Properties Ltd v Royal Bank of Scotland PLC* [2003] EWCA 1409, [2004] 1 WLR 997.

⁹¹⁸ *Tomlin v Luce* (1889) LR 43 Ch D 191; *Downsview Nominees Ltd v First City Corp* [1993] AC 295; *American Express International Banking Corporation v Hurley* [1986] BCLC 52, 61; *Burgess v Auger* [1998] BCLC 478; *Barclays Bank PLC v Kingston* [2006] EWHC 533, [2006] 2 Lloyd's Rep 59.

⁹¹⁹ *Downsview Nominees Ltd v First City Corp* [1993] AC 295.

⁹²⁰ *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949.

⁹²¹ See Sir Donald Nicholls V-C in *Palk v Mortgage Services Funding PLC* [1993] Ch 330, at 337–338.

⁹²² *Meftah v Lloyds TSB Bank PLC* [2001] 2 All ER (Comm) 741.

⁹²³ *Silven Properties Ltd v Royal Bank of Scotland PLC* [2003] EWCA 1409, [2004] 1 WLR 997.

⁹²⁴ *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949; *Silven Properties Ltd v Royal Bank of Scotland PLC* [2003] EWCA 1409, [2004] 1 WLR 997.

foregoing then it must stipulate for that expressly in the security instrument.⁹²⁵ Any agreed limitation on the duty owed by a security holder to a security giver when exercising its power of sale, such as the need to establish wilful misconduct, also applies in relation to a residual beneficiary to whom the security holder's duty was also owed.⁹²⁶

14.17.6.4 Mortgagee must not sell to itself

There is a settled rule that a mortgagee must not sell the secured assets to itself.⁹²⁷ The remedy of appropriation,⁹²⁸ permitted by the Financial Collateral Arrangements (No 2) Regulations 2003, is therefore an exception to this rule. However, in a recent case a sale to a mortgagee, which was agreed in advance in the mortgage agreement, was permitted.⁹²⁹ If a mortgagee sells to a company in which it has an interest, the burden of proof is reversed so that it is for the mortgagee and the company to show that the sale was in good faith and that the mortgagee took reasonable precautions to obtain the best price reasonably obtainable at the time.⁹³⁰ If there is a possibility of such conflict arising, a mortgagee would be well advised to seek an order from the court for sale, since, if a court thinks it proper to make an order, such a sale would be immune from challenge.⁹³¹

14.17.7 Appointment of an administrator

The 'holder of a qualifying floating charge' may appoint an administrator of a corporate debtor out of court.⁹³² Such a holder is, essentially, a secured creditor which holds comprehensive security (by one or more instruments) over the whole or substantially the whole of the debtor's assets, where such security includes a floating charge and the charge instrument purports to give the holder the power to appoint an administrator or an administrative receiver, or states that the relevant statutory provision applies to it.⁹³³ There are various restrictions and procedures that must be followed in making the appointment (including as to giving notice to the holder of a prior floating charge and the charge must have become enforceable)⁹³⁴ and the appointor must indemnify a person whom it has wrongly appointed.⁹³⁵

14.17.7.1 The company and the directors also have the power to appoint an administrator out of court,⁹³⁶ and this is often the preferred route, although it will

⁹²⁵ Ibid, at [18].

⁹²⁶ *Alpstream AG v PK Airfinance Sarl* [2013] EWHC 2370 (Comm); [2014] 1 All ER (Comm) 441 (at the time of writing there was an outstanding appeal).

⁹²⁷ *Martinson v Clowes* (1882) 21 Ch D 857.

⁹²⁸ See 14.7.6.4.1–14.7.6.4.2.

⁹²⁹ See *Royal Bank of Scotland plc v Highland Financial Partners LP* [2010] EWHC 3119 (Comm), where a bank who was in effect a mortgagee was contractually entitled to sell loans forming the collateral to itself providing certain conditions were fulfilled. The validity of this provision did not seem to have been in issue between the parties in the case.

⁹³⁰ *Tse Kwong Lam v Wong Chit Sen* [1983] 1 WLR 1349, 1355 (PC).

⁹³¹ *Palk v Mortgage Services Funding plc* [1993] Ch 330, 340 (CA).

⁹³² Para 14(1) of Sched B1 to the Insolvency Act 1986.

⁹³³ Paras 14(2) and (3) of Sched B1 to the Insolvency Act 1986.

⁹³⁴ See paras 7–9 and 15–20 of Sched B1 to the Insolvency Act 1986.

⁹³⁵ Para 21 of Sched B1 to the Insolvency Act 1986.

⁹³⁶ Para 22 of Sched B1 to the Insolvency Act 1986.

usually be as a result of pressure from the floating charge holder.⁹³⁷ However, the notice to be filed when making this appointment must state that the company is, or is likely to become, unable to pay its debts, while this is not necessary if the appointment is made by the qualifying floating charge holder.

14.17.7.2 Despite the power of appointment that is vested in the security holder, the administrator is an officer of the court⁹³⁸ and must perform his duties for the statutory purposes as laid down.⁹³⁹ Accordingly, he does not owe his duties to the appointor and the latter cannot give instructions to the administrator. Thus, the ability to appoint an administrator might be thought to be of limited benefit to a security holder. However, the security holder can choose the administrator and the appointment does allow an insolvency practitioner to take charge of the debtor company, which may lead to a more realistic appraisal and order of its affairs than the company's own management might have been able to achieve. The administrator might also be able to achieve a sale of the business of the company as a going concern, especially with the co-operation of the security holder. In fact, a practice has developed of so-called 'pre-packaged' administrations, under which the sale of the business and assets of the debtor company is organised in advance of the appointment of the administrator, who then effects the sale shortly after his appointment, with the co-operation of the security holder which appointed him. A word of caution must be sounded at this point. As mentioned above, the administrator has statutory duties, he is an officer of the court, and he must conduct the administration for the statutory purposes. He must therefore ensure that the transaction is one which it is proper for him to enter into on behalf of the company. Pre-packaged administrations, though common, have been the subject of much criticism, partly for lack of transparency, partly for potential damage to the interests of unsecured creditors and partly as they enable connected parties to buy the business at a low price. A Statement of Insolvency Practice (SIP 16) was issued in 2009, in order to improve transparency, and a wholesale review of pre-packs has just taken place.⁹⁴⁰ The review found that pre-packs had a valuable role to play, but that certain 'cleaning up' was needed, and made certain recommendations to be implemented by the market, mainly related to 'connected party' pre-packs.

14.17.7.3 Once an administrator has been appointed, there is a moratorium on the enforcement of all security, including quasi-security such as hire-purchase agreements and finance leases.⁹⁴¹ This moratorium does not apply, however, to security financial collateral arrangements.⁹⁴² The administrator, however, may realise the secured assets and may make a distribution to the secured creditors without leave of the court.⁹⁴³ As mentioned, in many cases the administrator will sell the business as a going concern: in that case, distributions would be made out of the sale proceeds as appropriate.

⁹³⁷ S Frisby, 'Not quite Warp Factor 2 yet? The Enterprise Act and Corporate Insolvency (Pt 1)' (2007) 22 *Journal of International Banking and Financial Law* 327.

⁹³⁸ Para 5 of Sched B1 to the Insolvency Act 1986.

⁹³⁹ Para 3 of Sched B1 to the Insolvency Act 1986.

⁹⁴⁰ The Graham review into Pre-pack Administration (June 2014).

⁹⁴¹ Para 43(2) of Sched B1 to the Insolvency Act 1986. The prohibition is extended to the period that is preliminary to the appointment of the administrator: see para 44 of the Act.

⁹⁴² Financial Collateral Arrangements (No 2) Regulations 2003 reg 8(1)(a).

⁹⁴³ Para 65(3) of Sched B1 to the Insolvency Act 1986.

14.17.8 Appointment of a receiver

A receiver may be appointed by the court under section 37 of the Supreme Court Act 1981 but that is unusual.⁹⁴⁴ Such a receiver must act fairly as an officer of the court.⁹⁴⁵ Such appointments at the behest of a security holder are rare and will not be explored further.

14.17.8.1 By far the greater number of appointments of receivers are made by security holders pursuant to their security, which will be the subject of the remaining discussion. There are two types of such receiver, being the receiver appointed over specific assets, and a receiver and manager who is appointed under comprehensive security given by a company, called an ‘administrative receiver’.

14.17.8.2 The power to appoint a receiver is limited by the provisions of the Insolvency Act 1986 which deal with administration. Essentially, any receiver who is in office must vacate his office if an administrator is appointed.⁹⁴⁶ Furthermore, the appointment of a receiver would amount to an act in enforcement of security, which is prohibited by the moratorium mentioned above unless the administrator consents or the court permits,⁹⁴⁷ neither of which would be likely. A floating charge holder cannot now appoint an administrative receiver unless the charge falls into one of the exceptions discussed below. In that situation, if an administrative receiver is in office then it is not possible for a company to go into administration, unless the security holder who appointed the administrative receiver consents⁹⁴⁸ (at which point the administrative receiver would have to vacate office).

14.17.8.3 A person who appoints, or who obtains a court appointment of, a receiver must give notice of the appointment to the Registrar of Companies within seven days of the appointment.⁹⁴⁹ When the receiver ceases to act, he must give notice of that fact to the Registrar.⁹⁵⁰

14.17.8.4 Receivers of specific assets

Section 101(1)(iii) of the Law of Property Act 1925 provides that a security holder under security made by deed may appoint a receiver. This is regulated by section 103 of the Act which, in turn, is usually overcome by an express provision in the security instrument, in accordance with section 101(3) of the Act. A receiver appointed under the statute is expressed by section 109(3) of the Act only to be a receiver of income. Accordingly, it is common in security instruments to use section 101(3) to extend the powers of the receiver so that he can manage the charged property and sell it. In the alternative, the security instrument might contain an express power of appointment of a receiver, as well as a statement of his powers. It should be noted that section 109(2) of the Act provides that the receiver is deemed to be the agent of the security giver, which alone is responsible for the receiver’s acts and omissions, unless the security

⁹⁴⁴ In *Masri v Consolidated Contractors International Co SAL* [2008] EWCA Civ 303, [2008] 2 Lloyd’s Rep 128, the Court of Appeal considered the situation where the court might appoint a receiver by way of equitable execution of a debt, including foreign debts and debts that might arise in the future which related to an asset.

⁹⁴⁵ *Re Newdigate Colliery Ltd* [1912] 1 Ch 468.

⁹⁴⁶ Para 41 of Sched B1 to the Insolvency Act 1986.

⁹⁴⁷ Para 43(2) of Sched B1 to the Insolvency Act 1986.

⁹⁴⁸ Para 39(1) of Sched B1 to the Insolvency Act 1986.

⁹⁴⁹ S 871(1) of the Companies Act 2006 (formerly s 405(1) of the Companies Act 1985).

⁹⁵⁰ S 871(2) of the Companies Act 2006 (formerly s 405(2) of the Companies Act 1985).

instrument provides otherwise. It would be a very rare security instrument which so provided. There is usually an express statement in the security instrument that the receiver acts as the agent of the security giver.

14.17.8.4.1 Essentially, this type of receiver is appointed to take possession of and manage the specific assets subject to the security and to receive the income from them, with the principal intention of selling the assets. The receiver may be appointed irrespective of whether the security giver is a corporate entity or an individual.

14.17.8.4.2 Duties of a receiver

The duties of a receiver in the exercise of his powers were reviewed in *Silven Properties Ltd v Royal Bank of Scotland PLC*⁹⁵¹ and what follows is largely a distillation of the decision in that case. A receiver has duties in equity, not common law.⁹⁵² The duties are owed to the security holder who appointed him, as well as to the security giver and others with an interest in the equity of redemption, but the duty to the security holder to bring about a repayment of the secured debt is paramount.⁹⁵³ Accordingly, the receiver's powers of management are not exercised for the benefit of the security giver but, rather, for the benefit of the security holder and are ancillary to that paramount obligation. If the receiver does breach his duty, that does not give rise to a claim in damages but, rather, to a duty to account. On the same basis as the duty of a security holder in exercising the power of sale, a receiver when selling property is obliged to take care to obtain the best price reasonably obtainable at the time of sale,⁹⁵⁴ but he is entitled to sell the property as he finds it without a duty to make any improvement or to await an increase in value.⁹⁵⁵

14.17.8.6.1 There are two important statutory duties of a receiver which must not be overlooked. Under section 40 of the Insolvency Act 1986, if the company is not in the course of liquidation, the receiver must apply recoveries out of assets subject to a floating charge (as taken) in payment of preferential creditors, ahead of the claims of the security holder. In addition, under section 176A of that Act, the receiver must set aside the prescribed part from the recoveries under such a charge to meet the claims of unsecured creditors.

14.17.9 Administrative Receivers.

Administrative receivership only applies where the security giver is a company, and is only available to a security holder in certain specific cases, defined below. The definition of an administrative receiver will be found in section 29(2) of the Insolvency Act 1986. It has a certain resonance with the definition of the holder of a qualifying floating charge. An administrative receiver is a receiver and manager appointed under comprehensive security over the whole or substantially the whole of the company's property, where such security comprises, or at least includes, a floating charge, no matter how insignificant the floating charge might be as a part of the

⁹⁵¹ [2003] EWCA 1409; [2004] 1 WLR 997, at [21]–[29].

⁹⁵² *Medforth v Blake* [2000] Ch 86; *Raja v Austin Gray* [2002] EWCA Civ 1965, [2003] BPIR 725.

⁹⁵³ *Downsview Nominees Ltd v First City Corp* [1993] AC 295; *Burgess v Auger* [1998] BCLC 478; *Barclays Bank PLC v Kingston* [2006] EWHC 533, [2006] 2 Lloyd's Rep 59.

⁹⁵⁴ *Downsview Nominees Ltd v First City Corp* [1993] AC 295; *Medforth v Blake* [2000] Ch 86; *Raja v Austin Gray* [2002] EWCA Civ 1965, [2003] BPIR 725.

⁹⁵⁵ *Garland v Ralph Pay & Ransom* [1984] 2 EGLR 147; *Routestone Ltd v Minorities Finance Ltd* [1997] BCC 180; *Meftah v Lloyds TSB Bank PLC* [2001] 2 All ER (Comm) 741.

overall package of security.⁹⁵⁶ By the appointment of an administrative receiver (if permitted), the secured creditor can prevent the appointment of an administrator of the company.⁹⁵⁷

14.7.9.1. Section 72A of the Insolvency Act 1986 provides that, with certain exceptions, an administrative receiver may not be appointed under security taken on or after the date that the section came into force, which was 15 September 2003.⁹⁵⁸ There is no restriction upon appointments made under security granted before that date, but this must now be reasonably rare. There are a number of exceptions to section 72A, where it remains possible to appoint an administrative receiver under security taken after the above-mentioned date. These are contained in sections 72B to 72H of the Act.⁹⁵⁹ The exceptions apply to the following situations: capital market arrangements (section 72B); public–private partnerships (section 72C); utility projects (section 72D); urban regeneration projects (section 72DA); project finance (section 72E); financial markets charges (section 72F); registered social landlords (section 72G); and protected railway, transport, and water companies (section 72GA). Some of these exceptions are discussed below.

14.17.9.2 Capital market arrangements (section 72B)

This exception is discussed at some length in Chapter 12. By way of summary, the exception applies to the appointment of an administrative receiver under an agreement that is or forms part of a ‘capital market arrangement’ which involves an actual or expected debt of at least £50 million (in any currency) and an arrangement for the issue of a capital market investment. The expressions ‘capital market arrangement’ and ‘capital market investment’ are defined in Schedule 2A to the Act.

14.17.9.3 Public–private partnerships (section 72C)

This exception applies to the appointment of an administrative receiver of a project company of a public–private partnership project which includes step-in rights.

14.17.9.3.1 A public–private partnership project is defined in the section as a project under which either:

- (a) the resources [for the project] are provided partly by one or more public bodies and partly by one or more private persons, or
- (b) [the project] is designed wholly or mainly to assist a public body to discharge a function.

14.17.9.3.2 The expression ‘resources’ is given a widely inclusive definition in Schedule 2A to the Act and that schedule also defines the expression ‘public body’. There is no statutory definition of function but it probably means a function which the relevant public body was established or exists to perform.

14.17.9.3.3 The meaning of ‘project’ is left undefined, although it will be noted that it is used in conjunction with the concepts of ‘project company’ and ‘public–private partnership project’. In *Feetum v Levy*,⁹⁶⁰ which was a case concerning the

⁹⁵⁶ *Re Croftbell Ltd* [1990] BCLC 844.

⁹⁵⁷ Paras 17, 25, and 39 of Sched 1 to the Insolvency Act 1986.

⁹⁵⁸ The Insolvency Act 1986, Section 72A (Appointed Date) Order 2003 (SI 2003/2095).

⁹⁵⁹ S 72H of the Act provides that additions, deletions, and amendments to the exceptions may be made by secondary legislation.

⁹⁶⁰ [2005] EWHC 349 (Ch), [2005] 1 WLR 2576 (upheld on appeal: *Cabvision v Feetum* [2005] EWCA Civ 1601, [2005] Ch 585).

exception in section 72E but which would also be relevant in the present context, Lewison J, whilst declining to provide a complete definition of the word as it is used in these sections of the Act, said that the meaning of ‘project’ was not limited just to construction and engineering operations. It would also include the scheme in that case where the relevant company had entered into an agreement to purchase IT rights, which it intended to exploit.

14.17.9.3.4 A ‘project company’ is, essentially, a company which is dedicated to the project. In more detail, it is defined in paragraph 7 of Schedule 2A for the purposes of the exceptions contained in section 72C and other sections, as follows:

- (1) . . . a company is a ‘project company’ of a project if—
 - (a) it holds property for the purpose of the project,
 - (b) it has sole or principal responsibility under an agreement for carrying out all or part of the project,
 - (c) it is one of a number of companies which together carry out the project,
 - (d) it has the purpose of supplying finance to enable the project to be carried out, or
 - (e) it is the holding company of a company within any of paragraphs (a) to (d).
- (2) But a company is not a ‘project company’ of a project if—
 - (a) it performs a function within sub-paragraph (1)(a) to (d) or is within sub-paragraph (1)(e), but
 - (b) it also performs a function which is not—
 - (i) within sub-paragraph (1)(a) to (d),
 - (ii) related to a function within sub-paragraph (1)(a) to (d), or
 - (iii) related to the project.
- (3) For the purpose of this paragraph a company carries out all or part of a project whether or not it acts wholly or partly through agents.

14.17.9.3.5 ‘Step-in rights’ in relation to a project are defined in paragraph 6 of Schedule 2A for the purposes of this and other exceptions, as follows:

- (1) . . . a project has ‘step-in rights’ if a person who provides finance in connection with the project has a conditional entitlement under an agreement to—
 - (a) assume sole or principal responsibility under an agreement for carrying out all or part of the project, or
 - (b) make arrangements for carrying out all or part of the project.
- (2) In sub-paragraph (1) a reference to the provision of finance includes a reference to the provision of an indemnity.

14.17.9.3.5.1 In considering the definition of ‘step-in rights’ it should be noted that the word ‘agreement’ is given a widely inclusive meaning in Schedule 2A, to include ‘an agreement or undertaking effected by (a) contract, (b) deed, or (c) any other instrument intended to have effect in accordance with’ the law of any jurisdiction. It should also be noted that the definition requires that it is the person who provides the finance (including by the provision of an indemnity) who must have the conditional entitlement to assume the relevant responsibility or make the arrangements. A ‘person’ is defined in Schedule 2A to include a partnership or another unincorporated group of persons, so a syndicate of lenders could be considered to be a person which has provided the finance. However, it is not so clear that a security trustee, which

simply held the security on behalf of the syndicate, would be considered to be such a person, although perhaps a facility agent acting as agent within the authority of the syndicate might be considered sufficient to meet the requirement.⁹⁶¹

14.17.9.3.5.2 In *Feetum v Levy*, it was argued that the security holder (whose security was to secure an indemnity within sub-paragraph (2) of the definition of ‘step-in rights’) had the relevant entitlement by virtue of its right under the security either to appoint an administrative receiver of the project company or to appoint an administrator of the company. That argument was dismissed by the judge. If an administrative receiver was appointed, he would be acting as the agent of the company, as expressly provided in the security document (and, incidentally, as also provided by section 44(1)(a) of the Insolvency Act 1986). As such, the receiver would not be acting on behalf of the security holder but on behalf of the project company, and it would be up to the receiver to decide whether and how he should act. Similarly, an administrator would not be acting on behalf of the secured creditor who appointed him but would act on behalf of the company pursuant to his statutory powers. Hence, it could not be said that the receiver or the administrator was assuming responsibility on behalf of the secured creditor to carry out the project, nor could the appointment of either of them be tantamount to the secured creditor making arrangements for carrying out the project.

14.17.9.4 Project finance (section 72E)

This exception permits the appointment of an administrative receiver of a project company of a project which is a ‘financed project’ and includes step-in rights. As to the concepts of a ‘project company’, a ‘project’, and ‘step-in rights’, see the discussion above concerning section 72C of the Act. See also that discussion as to the meaning of ‘agreement’, which is used in the definition that is about to be mentioned.

14.17.9.4.1 Section 72E provides that:

a project is ‘financed’ if under an agreement relating to the project a project company incurs, or when the agreement is entered into is expected to incur, a debt of at least £50m for the purpose of carrying out the project.

14.17.9.4.2 It should be noted that in paragraph 5 of Schedule 2A to the Act, it is provided that the debt of £50 million:

- (a) may be incurred at any time during the life of the . . . financed project, and
- (b) may be expressed wholly or partly in foreign currency (in which case the sterling equivalent shall be calculated as at the time when the project begins).

14.17.9.4.3 Guidance as to the components of the definition of ‘financed project’ was provided by Lewison J in *Feetum v Levy*.⁹⁶² His Lordship said, first, that although the debt must be incurred by a project company, it need not necessarily be incurred by the project company over which the administrative receiver is appointed. Secondly, that the debt must be incurred under an agreement relating to the project, but not necessarily the agreement under which the administrative receiver is appointed.

⁹⁶¹ See the distinction between the role of a security trustee and a facility agent that was drawn in *British Energy Power & Trading Ltd v Credit Suisse* [2007] EWCA Civ 53, [2008] 2 All ER (Comm) 524.

⁹⁶² [2005] EWHC 349 (Ch), [2005] 1 WLR 2576 (upheld on appeal: *Cabvision v Feetum* [2005] EWCA Civ 1601, [2005] Ch 585).

Thirdly, as to the requirement that a debt of at least £50 million is incurred (or, when the agreement is entered into, is expected to be incurred) under an agreement relating to the project, his Lordship said that, as a matter of construction of the statutory wording, the ‘agreement’ had to be the same agreement under which the debt was incurred, or, alternatively, was expected to be incurred, so as to finance the project. Fourthly, his Lordship distinguished between hope and the more objective concept of an expectation, the latter being what was required if there was to be an expectation of incurring a debt of at least £50 million under the relevant agreement. An expectation depends on the likelihood of meeting the conditions to its fulfilment. He also noted that the section requires an expectation that ‘at least’ £50 million will be borrowed, rather than ‘up to’ a figure, even if higher. Whilst a borrower might initially have hoped that it could borrow above the figure of £50 million, there would not be the requisite expectation if, in fact, it had realistically been entitled under the agreement to borrow only a lower sum because of circumstances that were known or appreciated at the time.

14.17.9.5. The role and powers of an administrative receiver An administrative receiver acts as the agent of the company until it goes into liquidation.⁹⁶³ In that role, he has extensive powers to manage and realise the business and assets of the company.⁹⁶⁴ In effect, his powers override the management functions of the directors, although technically they remain in office with responsibilities under the Companies Acts and some very limited power to bring proceedings, so long as that does not impinge on the assets that are subject to the security.⁹⁶⁵ The administrative receiver is personally liable on any contract that he enters into in carrying out his functions, unless the contract otherwise provides (as it will almost invariably do).⁹⁶⁶ He is also liable for existing contracts of employment that he ‘adopts’.⁹⁶⁷

14.17.8.5.2.1 As the administrative receiver acts as the agent of the company, the person who appointed him is not responsible for his acts and defaults, unless the appointor intervenes in the receivership, such as by giving the receiver instructions as to the conduct of the receivership.⁹⁶⁸ Despite the fact that he is the agent of the company and not the agent of the security holder which appointed him, the receiver owes his primary duty to the appointor, to realise the assets, and pay off the secured debt.⁹⁶⁹ The company, on whose behalf he acts, has no right to say who should be

⁹⁶³ S 44(1)(a) of the Insolvency Act 1986. Because he acts as its agent and the company alone is responsible for his actions, the receiver should not normally be made liable under a third party costs order for unsuccessful litigation which the receiver had caused the company to bring: *Dolphin Quays Developments Ltd v Mills* [2007] EWHC 1180 (Ch), [2007] 4 All ER 503 (upheld [2008] EWCA Civ 385, but with less emphasis on the importance of an element of impropriety or unreasonableness as a necessary factor in deciding if the order should be made).

⁹⁶⁴ S 42(1) of the Insolvency Act 1986.

⁹⁶⁵ *Newhart Developments Ltd v Co-operative Commercial Bank Ltd* [1978] QB 814; *Tudor Grange Holdings Ltd v Citibank NA* [1992] Ch 53; *GE Capital Finance Ltd v Sutton* [2004] EWCA Civ 315, [2004] 2 BCLC 662.

⁹⁶⁶ S 44(1)(b) of the Insolvency Act 1986. He is entitled to an indemnity out of the assets of the company for that liability: s 44(1)(c).

⁹⁶⁷ S 44(1)(b) of the Insolvency Act 1986. Again, he has an indemnity as just mentioned.

⁹⁶⁸ *American Express International Banking Corp v Hurley* [1985] 3 All ER 564.

⁹⁶⁹ *Re B Johnson & Co (Builders) Ltd* [1955] Ch 661; *Gomba Holdings UK Ltd v Homan* [1986] 1 WLR 1301; *Downsview Nominees Ltd v First City Corp Ltd* [1993] AC 295; *Medforth v Blake* [2000] Ch 86; *Silven Properties Ltd v Royal Bank of Scotland PLC* [2003] EWCA 1409, [2004] 1 WLR 997.

appointed, to dismiss the receiver, or to give him instructions.⁹⁷⁰ In a sense, this leads to something of a split personality.

14.17.8.5.2.2 The position of the receiver concerning existing contracts⁹⁷¹ that were in place prior to his appointment reflects a combination of factors: first, his position as the agent of the company; secondly, the fact that he is appointed under security that is or has become fixed security; thirdly, his primary duty to manage that security so as to pay off the secured debt. The consequence of this is that, generally speaking, the receiver is not bound by such contracts and can cause the company to breach them by not performing them.⁹⁷² Whilst the company may incur a liability in damages due to the breach, the receiver will not be personally liable for causing or procuring a breach of contract.⁹⁷³

14.17.8.5.2.3 Notwithstanding what has just been said, a receiver will be bound by an interest that ranks ahead of the security under which he was appointed.⁹⁷⁴ In addition, it has been said that he may not seriously damage the goodwill of the company if there might be a surplus of assets after the security has been discharged or if the security does not extend to all of the assets of the company and his actions might impair the ability of the company to continue to trade with its other assets.⁹⁷⁵ It has also been said that if a pre-existing contract were of a type that would normally be susceptible to an order for specific performance, then the court may be willing to make such an order, even though the receiver does not wish to perform the contract, unless the receiver has decided to end the business.⁹⁷⁶ It is submitted that this ignores the interest of the security under which the receiver was appointed. By ordering performance of the contract, the company will probably have to use charged assets over which the security holder has a paramount claim.

14.17.8.5.2.4 The agency of the administrative receiver ends if the company goes into liquidation.⁹⁷⁷ This means that he can no longer run the business of the company. Nonetheless, the receiver remains in possession of the assets over which he was appointed. The loss of his agency to act on behalf of the company does not mean that he becomes the agent of the appointor.⁹⁷⁸ He remains in possession of the secured assets and is entitled to sell the assets in the realisation of the security under which he was appointed.⁹⁷⁹ The receiver may also continue litigation which had been commenced before the liquidation, whether it had been commenced by the company or by the receiver.⁹⁸⁰

⁹⁷⁰ See Rigby LJ in *Gaskell v Gosling* [1896] 1 QB 669, at 692 (approved [1897] AC 575); *Silven Properties Ltd v Royal Bank of Scotland PLC* [2003] EWCA 1409, [2004] 1 WLR 997.

⁹⁷¹ Except, as already mentioned, existing employment contracts that he 'adopts'.

⁹⁷² This should be contrasted with the position of an administrator: see *Astor Chemicals Ltd v Synthetic Technology Ltd* [1990] BCC 97.

⁹⁷³ *Airlines Airspares Ltd v Handley Page Ltd* [1970] Ch 193; *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148.

⁹⁷⁴ *Freevale Ltd v Metrostore (Holdings) Ltd* [1984] Ch 199.

⁹⁷⁵ See *Airlines Airspares Ltd v Handley Page Ltd* [1970] Ch 193, at 198 and *Astor Chemicals Ltd v Synthetic Technology Ltd* [1990] BCC 97, at 105.

⁹⁷⁶ *Land Rover Group Ltd v UPF (UK) Ltd* [2002] EWHC 3183 (QB), [2003] 2 BCLC 222. The approach in that case should be contrasted with that taken in *Re Trans Tec Automotive (Campsie) Ltd* [2001] BCC 403.

⁹⁷⁷ S 44(1)(a) of the Insolvency Act 1986.

⁹⁷⁸ *Gosling v Gaskell* [1897] AC 575.

⁹⁷⁹ *Gosling v Gaskell* [1897] AC 575; *Sowman v David Samuel Trust Ltd* [1978] 1 WLR 22.

⁹⁸⁰ *Mills v Birchall* [2008] EWCA Civ 385, at [27].

