Clarificatory evolutionary reform

CLARIFICATORY EVOLUTIONARY REFORM - THE IMPORTANCE OF THE SCOTTISH LAW COMMISSION'S DISCUSSION PAPER ON HERITABLE SECURITIES: PRE –DEFAULT

A. Introduction

In June 2019 the Scottish Law Commission issued its discussion paper on heritable securities, pre-default (the "**Discussion Paper**").[1] At first glance, this seems to be merely what it purports to be: another discussion paper by the Scottish Law Commission (the "**SLC**"), which should be responded to rather than the subject of commentary in and of itself. However, the purpose of this article is to reflect that the mere presence of this paper sets out a very important development within the area of rights in security and for Scots law as a whole, the majority of which is highly beneficial to Scots law.

There are three primary reasons that the Discussion Paper is so important. The first is that the area which the Discussion Paper examines was subject to an almost full statement in 1970 based on a detailed report.[2] Whilst 50 years is a long time, in the context of Scottish legal reform it is practically yesterday.[3] Accordingly, the Scottish Law Commission is re-visiting an area which has already been the subject of legislative reform. The true import of this is summed up by the SLC's final line in its chapter on "History and current law" which forms the basis for the title of this article:

> "The case for reform is strong, although such reform should clearly be on an evolutionary rather than revolutionary basis."[4]

The importance of this is discussed in part B of this comment.

The second area of importance lies in the goals of this evolutionary rather than revolutionary project: to create a proposal within the competence of the Scottish Parliament. This is discussed in part C of this comment.

The final area of key importance of the Discussion Paper is its theoretical approach to the nature of rights in security. In particular, the SLC wrestle with the rather conceptually difficult standard security which secures non-monetary obligations, or security *ad factum praestandum*,[5] and the concept of security over security. The importance of the SLC's approach to the conception of rights in security is discussed in part D of this comment.

B. Implications for Scots Law

The Discussion Paper's subject matter is heritable securities. The vast majority of the legal regime for heritable securities is contained in the Conveyancing and Feudal Reform (Scotland) Act 1970.[6] This Act revolutionised the law of heritable securities, by replacing the *ex facie* absolute transfer qualified by a 'back letter' which was the method almost always used in practice with a true security, being a

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[1] Scottish Law Commission Discussion Paper No 168 "Discussion Paper on Heritable Securities: Pre-default" June 2019.

[2] Discussion Paper, paras 2.18 – 2.31. The existing regime retains gaps – for example, ejection is still dealt with by the Heritably Securities (Scotland) Act 1894.

[3] See the reflections on the first 50 years of the SLC in Lord Pentland "The Scottish Law Commission and the future of law reform in Scotland" 2016 Juridical Review 169.

[4] Discussion Paper, para 2.72.

[5] Discussion Paper, paras 4.34 – 4.73.

[6] Some of the legal regime obviously follows that act, and some pre-dates it – for example discussion in Discussion paper paras 3.43 – 3.49.

subordinate real right in the encumbered asset.[7] Whilst it had a short legislative passage through the UK Parliament,[8] the 1970 Act was introduced following an in depth report by Professor Halliday.[9] Accordingly, the 1970 Act was the result of a reasoned approach to the area of law in question. Indeed, the SLC states:

> "While the 1970 Act can clearly be improved upon, it is not fundamentally broken. It was a significant step forward from the law which pre-dated it. As will be seen, our view is that many of the pillars, including that there should only be one form of conventional heritable security, should be retained."[10]

The first area of importance of the Discussion Paper is, therefore, that the SLC is re-visiting this area of law at all. The decision to open discussion on the operation of such an area has great importance for Scots law. The quality of laws relating to security has been empirically linked to the access to finance within such a jurisdiction.[11] Any re-examination of such laws is therefore welcome. Indeed, it is more than welcome that the SLC is undertaking such examination. When compared to England & Wales, Scotland is a much smaller jurisdiction. The result is that fewer transactions are conducted under Scots law. A lower number of transactions opens up fewer opportunities for disputes.[12] Fewer disputes means fewer cases coming to court to explore any issues which are left unresolved by the existing legal framework. As a result, there are fewer opportunities for the courts to resolve any such unresolved issues in Scotland than there are in England & Wales. This can mean that areas of Scots law remain untested in the courts and therefore legally uncertain for longer than areas of English law. If the courts do not have the opportunity to make such decisions then Scots law will fall behind its southern neighbour unless some alternative body adopts the role of proposing a constant and smooth evolution of Scots law over time. It is right and fitting that the SLC undertakes this role. Indeed, this places a higher burden on the SLC than exists for its southern counterpart. The SLC identifies evolutionary and revolutionary reform. Within the concept of evolutionary reform we can identify two further categories – clarification (clarifying legislation/case law to provide certainty by a definitive interpretation) and modification (amending or updating existing laws). Whilst courts are able to, given the correct dispute, make clarificatory evolutionary changes to law, they are limited when it comes to making revolutionary changes or modificatory evolutionary changes. This means that the Law Commission for England and Wales can primarily consider revolutionary legal reforms and modificatory evolutionary reforms, but the SLC has to look at revolutionary reforms, modificatory evolutionary reforms and clarificatory evolutionary reforms. For example, whilst it was clear that execution of a document in counterpart was a valid method of execution under English law, the position was unclear under Scots law and required SLC clarificatory evolutionary reform.[13]

Ironically, on one level this matters less in the context of heritable securities as someone buying Scottish land has to use Scots law in respect of the conveyance of such land and the grant of security

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[7] See Discussion Paper, paras 2.14 – 2.16. The *ex facie* absolute transfer was not the only method of creating security over land pre-1970 Act. Forms of subordinate real rights did exist but, for the reasons outlined by the SLC in the Discussion Paper, each was unsatisfactory.

[8] Discussion Paper, para 2.34.

[9] Discussion Paper, paras 2.18 – 2.31.

[10] Discussion Paper, para 1.19.

[11] See discussion in J Hardman "Some Legal Determinants of External Finance in Scotland: Reply to Lord Hodge" (2017) 21 Edinburgh Law Review 30.

[12] All things being equal. See discussion in P S Hodge "Does Scotland need its own commercial law?" (2015) 19 Edinburgh law Review 299 .

[13] See Scottish Law Commission Report No 231 "Review of Contract Law – Report on Formation of Contract: Execution in Counterpart" April 2013 which became the Legal Writings (Counterparts and Delivery) (Scotland) Act 2015. See discussion in J Hardman "Necessary and Balanced? Critical Analysis of the Legal Writings (Counterparts and delivery) (Scotland) Act 2015" 2016(3) Juridical Review 177.

over it.[14] This means that there is less of a risk of Scots law being avoided for the purchase of Scottish land until any unclear areas are clarified. However, Scots law may be avoided if any uncertainties provided sufficient concern to cause an investor to purchase land in a different jurisdiction. In addition, in other areas of law there is more of an option to elect to utilise a certain legal system. For example, there is generally a freedom for contracting parties in choosing their preferred governing law of their contractual arrangements.[15] Similarly, parties to litigation are known to "forum shop" to find their preferred court to hear such litigation.[16] If Scots private law evolution falls behind the natural evolution of other jurisdictions, then Scotland's comparative portions of such markets may also fall behind. In addition, certainty must be a beneficial aim in and of itself.

Ultimately, the SLC's decision to explore a topic so (comparatively) recently reformed to attempt to undertake minor evolutionary (both modificatory and clarificatory) updates to the core framework should be applauded. There are several other areas which could also benefit from this approach. For example, in the context of written obligations, 25 years ago the Requirements of Writing (Scotland) Act 1995 was equally as revolutionary as the 1970 Act was 50 years ago to heritable securities.[17] Amongst many wide reaching reforms, it allowed companies to sign Scots law documents in a very permissive manner – enabling anyone authorised to[18] bind the company by signing a document on their own, made self-proving by the addition of a witness.[19] At the time, English rules of execution required two officers of the company to sign[20] in order to bind a company under an English law deed. This overall framework, as with the 1970 Act, remains generally sound, and has been modified,[21] but there are some areas which are ripe for reform: such as the formatting requirements prescribed by the 1995 Act[22] which do not quite meet the current needs of twenty-first century technology. Similarly, given the lack of cases on the terms of the 1995 Act, there are areas which would benefit from clarificatory evolutionary reforms – for example probative execution by companies acting through their corporate directors under Scots law.

It is therefore hoped that the SLC expands its evolutionary (primarily clarificatory, but also modificatory) approaches to almost every area of Scots law to ensure that Scots law remains competitive and fit for purpose, especially as it is harder for the judiciary to fulfil this role in Scotland given the comparatively fewer cases that reach court. It is, of course, acknowledged that the ability for the SLC to do so is subject to restraints on resource. The arguments in this comment would encourage an increase in such resource to the SLC.

C. Competence

The benefit of clarificatory evolution through court process is that the court functions as the creator of legal analysis and enactor of such clarification: their judgment outlines the ambiguity and evaluates two approaches to resolve it, and the order enacts their preferred interpretation. Under the SLC

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[14] See *Rangers Football Club plc, Noters* [2012] CSOH 55 for evidence of the muscularity of Scottish courts on the choice of law of inherently Scottish assets.

[15] See H L Macqueen "Quo vadis?" 2018 Juridical Review 9 at 14. See also the Rome I regulation which is the principal EU legislation in this area - Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations.

[16] In the context of insolvency, see P J Omar "The Inevitability of 'Insolvency Tourism'" 2015 Netherlands International Law Review 429. See also the Brussels I regulation which is the primary EU legislation in this area - Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

[17] See discussion in D J Cusine and R Rennie "Standard Securities" 2nd edn (Edinburgh: Butterworths, 2002) ch 2.

[18] Requirements of Writing (Scotland) Act 1995 para 3(1) of Sch 2.

[19] Requirements of Writing (Scotland) Act 1995 para 3(5)(a) of Sch 2.

[20] The requirements for sealing was abolished under English law by the Law of Property (Miscellaneous Provisions) Act 1989 s1, which required a director and the secretary or two directors to sign until the enactment of s44 of the Companies Act 2006 in 2008, over 10 years after Scots law reforms.

[21] E.g. Legal Writing (Counterparts and Delivery) (Scotland) Act 2015.

[22] E.g. Requirements of Writing (Scotland) Act 1995 s7(1).

clarificatory evolutionary model outlined above, the SLC creates the proposal for reform but it requires a legislative body to enact it. The nature of clarificatory evolutionary reform may indicate that there is less of a core problem to be resolved. Unlike the pre-1970 position, there is no pressing need for radical reform outlined in the Discussion Paper. This means that any such reform is likely to attract less political attention than any revolutionary reforms which are required. The ability to deliver such reforms must be as important as the proposal for evolutionary reforms themselves.

It makes sense for the reforms to be designed to fall within the competence of the Scottish Parliament,[23] which should in theory have more time to discuss Scots law reforms than Westminster has.[24] Indeed, given that the subject matter of the Discussion Paper is devolved, any recommendations eventually made by the SLC require, politically, to be enacted by the Scottish Parliament. However, the point arises on a wider basis for any proposed reform of Scots law. It is clear that for revolutionary and evolutionary reforms (both clarificatory and modificatory), there is a strong argument to be made for a trade-off between perfection and deliverability: to propose a purposefully less perfect reform in order to ensure that it can be enacted in the simplest manner. This is especially the case given that certain of the SLC's previous recommended reforms on rights in security have not been fully implemented.[25] This may involve sacrificing a wide-ranging but theoretically pure reform which requires input from several legislative bodies to create a less pure reform which can fit within a neater parliamentary competence.

However, this trade-off is not working the way it should. The SLC's previous recommendations, in the area of rights in security, were set out in the Report.[26] This recommended reform was revolutionary rather than evolutionary in nature. It was universally praised.[27] It was also designed specifically to be capable of being passed by the Scottish Parliament, with express and critical engagement being undertaken for the trade-off acknowledged above.[28] And yet it is not yet law, nor is any legislative time yet scheduled to discuss it. Indeed the Scottish Government's response to the Report contains two contradictory statements: "I understand the business sector is very keen to see the proposed legislation move forward" is followed almost immediately by "we will need to consult with business and the financial sector on the proposals."[29] As yet, whilst the Scottish Government continue to take informal soundings to progress matters, no formal proposal has been taken forward either to follow the SLC's recommendations on the basis of the keenness of the business sector for the reforms, or to commence verification of that enthusiasm. The Scottish Government's 2019-2020 programme refers to a proposal to carry out some focused consultation for the reform on page 135 of a 158 page document,[30] but no further details are provided. As a result, a necessary and popular

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[23] Discussion Paper, para 1.31.

[24] e.g Scottish Law Commission Report No 249 "Report on Moveable Transactions" December 2017 (the "**Report**") para 18.53

[25] E.g. the Bankruptcy and Diligence etc. (Scotland) Act 2007 part 2 as discussed in the Report pars 18.41 – 18.43.

[26] The Report.

[27] For a reasonably typical example see A J D MacPherson "The future of moveable security in Scots law? Comments on the Scottish Law Commission's Report on Moveable Transactions" 2018 Juridical Review 98. The only published piece with any negative elements can be found in J Hardman "Three Steps Forward, Two Steps Back: a view from corporate security practice of the Moveable Transactions (Scotland) Bill 22 Edinburgh Law Review 267, but even this stated "The Bill should be implemented without delay…(if it were necessary) the Bill should be adopted in its current form rather than the current issues preventing it from becoming law" (268).

[28] See discussion in Report paras 1.44 and 18.53.

[29] https://www.scotlawcom.gov.uk/files/8615/4936/1366/Response_from_the_Scottish_Government_to_Reports_on_Contract_Law_Report_No_252_and_Moveable_Transactions_Report_No_249.pdf

[30] https://www.gov.scot/binaries/content/documents/govscot/publications/publication/2019/09/protecting-scotlands-future-governments-programme-scotland-2019-20/documents/governments-programme-scotland-2019-20/governments-programme-scotland-2019-20/govscot%3Adocument/governments-programme-scotland-2019-20.pdf

revolutionary reform remains formally in stasis. This reform was, by design, not the perfect reform for Scots law, but was chosen on the basis of deliverability which has not yet come to pass.

This has implications for the SLC's role as guardian of clarificatory evolution of law in Scotland. If the Scottish Government and Scottish Parliament cannot or will not undertake the universally popular revolutionary reforms outlined in the Report, how will it find the time or inclination to enact any clarificatory evolutionary measures which arise from the context of the Discussion Paper or other discussion papers? If Scots law is to avoid falling behind potentially competitive legal systems it becomes vital that the relevant Government and Parliament acts promptly on the SLC's recommendations.

D. Nature of Rights in Security

The implication for Scots law of the foregoing is, in and of itself, sufficient to justify comment. However, the Discussion Paper also impacts on three main areas of theoretical discussion of rights in security.

Firstly, the Discussion Paper is the first of two projected discussion papers on heritable securities.[31] The second will relate to post-default matters. The majority of criticism of the 1970 Act regime relates to enforcement of standard securities.[32] Whilst it is logical to discuss pre-default prior to post-default, the latter is where the majority of reforms are needed. It is therefore of importance that the Discussion Paper relates to pre-default matters. The SLC has made a key decision by not prioritising the enforcement aspects of heritable securities, and this decision has a number of effects. It shows the strength of the evolutionary approach to reform: the SLC will look at the matter holistically in logical order and make all necessary recommendations at the same time, regardless of which areas of the law are most criticised. This will help avoid a sticking-plaster approach to reform, and enable the smoothest evolutionary approach. It also helps advance the theoretical approach to rights in security. By concentrating on the grant of security, the SLC helps to highlight that laws related to rights in security must be efficient from the perspective of granter, recipient and third parties at various stages of the lifecycle of the right in security (grant, existence, transfer and enforcement/release). Whilst enforcement of heritable securities might be the issue that attracts most attention, not all heritable securities are enforced. Accordingly any reform which fixed enforcement issues but made matters worse during pre-enforcement would be a counterproductive approach. The SLC's process avoids this risk, whilst also reminding all of the importance of pre-enforcement when it comes to rights in security.

Secondly, the Discussion Paper undertakes an important analysis delineating a right in security. Under the 1970 Act, heritable securities can secure non-monetary obligations, known as *ad facta praestanda* obligations, such as a positive obligation to build something on the land[33] It is unclear whether such obligations have a role in rights in security at all. The Discussion Paper contains a very thorough theoretical and comparative analysis[34] of both sides of this debate to invite responses on removing the ability to grant such security or clarify that such security actually secures any damages arising from a failure to comply with the obligation.[35] This continues the SLC's sterling work in providing a holistic theoretical framework for the operation of rights in security under Scots law.

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[31] Discussion Paper, paras 1.21 – 1.23

[32] See J Hardman "Some Legal Determinants of External Finance in Scotland: Reply to Lord Hodge" (2017) 21 Edinburgh Law Review 30 at 48-49

[33] Discussion Paper, paras 4.34-4.36

[34] Discussion Paper, paras 4.37–4.65. Although, it should be noted that there are some elements of the grant of security which are not included in the Discussion Paper's comparative analysis – for example a lot of jurisdictions cited require large notarial fees to be expended as part of the grant of security, which incurs transaction costs and affects efficiency, but these costs are not referred to.

[35] Discussion Paper, para 4.85

Thirdly, the SLC further advances theoretical understanding of rights in security by exploring the nature of security over security. It is currently possible to grant a standard security over a standard security.[36] This does not fit neatly into the conceptual framework of Scots law for two main reasons. Firstly, as a standard security cannot be separated from the debt it secures,[37] unless such standard security over a standard security is backed by an assignation in security of the debt, it would prove to be meaningless. This narrows the circumstances in which a standard security over a standard security is relevant to granting security over secured debt. Secondly, if a standard security over a standard security were to be backed by an assignation in security of the debt (which is common in structured finance transactions such as securitisations), this process would provide the ultimate creditor with a subordinate real right in the standard security. Obtaining an assignation in security of the debt would result in the debt being absolutely transferred to the ultimate creditor – also causing a separation of the debt and the standard security. Of much more importance is the ability to transfer a standard security by assignation. The 1970 Act regime on this subject has recently created some directly contradictory case law.[38] This provided some key insight into the difficulty in relying on Scots courts for clarificatory evolutionary reform – the cases appeared in 2017, after the 1970 Act regime had been in place for 47 years. Even now, the position as to which of the sides of this debate is correct is not clear. As the SLC states:

> "In a careful analysis, Professors Reid and Gretton weigh up the arguments and conclude that the position is 'uncertain'. The new legislation that results from this project must make the position clear."[39]

In other words, the courts have not adequately undertaken a clarificatory evolution role in the context of assignations of standard securities. They have, however, highlighted an ambiguity which the SLC will seek to remedy: clarificatory evolution in action. The author intends no criticism of the courts through this analysis; this observation is merely a statement of fact. It is a consequence of each of the three cases which have caused the contradictory outcome being first instance decisions which have not been appealed. In the event that any of these three had been appealed to the Inner House (or the UK Supreme Court), the court would (or, at least, could) have undertaken a clarificatory evolutionary reform by pronouncing a clear and binding precedent. The lack of volume of cases through the Scottish courts means not just a lower number of first instance cases, but a lower number of such cases being appealed to higher courts. Without any such appeal to a higher court, we are unable to obtain a binding precedent for the lower courts. This provides a structural restraint for judicial clarificatory evolutionary reform.

E. Conclusion

There are points of substance on the proposals raised in the Discussion Paper which require to be responded to. However, it is logical and right that responses are required to SLC initial discussion papers. Of much more importance is the willingness of the SLC to undertake part of the clarificatory evolutionary role of Scots law. Given that the lack of volume of litigation means that they are the best body able to undertake such a role, their willingness should be embraced, especially when the content of such evolutionary development provides such enrichment of the theoretical approach undertaken by Scots law.

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[36] Discussion Paper, paras 5.25 – 5.30
[37] Discussion Paper, para 5.27
[38] See *OneSavings Bank plc v Burns* [2017] SC BAN 20, *Shear v Clipper Holding II SARL* (Outer House, unreported) and *Promotoria (Henrico) Ltd v Portico Holdings (Scotland) Ltd* [2018] SC GRE 5.
[39] Discussion Paper, para 10.56

Sadly for the Scottish legal system, the SLC cannot ensure the necessary evolution (or revolution) of Scots law on its own. For reforms of private law, its counterparts are, naturally, the Scottish Government and the Scottish Parliament. They need to play their parts too.