

USER GUIDE
for
SECURED
TRANSACTIONS CODE

July 2015

- 1 The purpose of this User Guide is briefly to explain what we have put in the Code, and why.
- 2 The important point to stress is that the Code is a starting point for discussion. We want to prompt a dialogue about whether a Code is useful and, if it is, what it should contain. The current text is a starting point for that discussion.

Part 1: What is a charge?

- 3 This part contains the power to create a charge and explains what a charge is and how it differs from an outright interest.
- 4 Our starting point is the current law – because we believe that charges work well in practice – but we have tried to simplify and modernise the law where possible.
- 5 The intention is that there should be a single security interest – the charge – with a single set of rules. But the Code will only apply to secured transactions, and therefore the underlying property law principles relating to outright transactions will continue in their current form. For that reason, it has been thought necessary to provide for legal charges, as well as equitable ones. This is not intended to affect the position between the chargor and the chargee – that will be the same whether the charge is legal or equitable. But the distinction is necessary when dealing with priority issues (see part 8 below).

Part 2: Creation and effectiveness

- 6 In section 5, a distinction is drawn between the creation and the effectiveness of a charge. The reason for this is to deal with registrable charges.
- 7 Under the current law, the chargee has twenty-one days within which to register the charge and this creates what has been described as the “twenty-one day invisibility period”. This has not created material problems in practice, but the introduction of a Code would enable it to be overcome. The Code therefore draws a distinction between the creation and effectiveness of a charge. A charge is created in the normal way, at which time the personal rights and duties arise between the parties. But, if the charge is registrable, it only becomes effective as a proprietary interest on registration. This avoids the invisibility period.
- 8 We envisage that registration will be electronic and automatic, but it would be possible to introduce a priority search system if that were thought necessary. Since the

effectiveness of a charge will be dependent on registration, the system will need to be robust.

- 9 The other major change introduced in part 2 is that it provides that the charge is the only form of security interest which will be available. Mortgages, security assignments, pledges and contractual liens are abolished.
- 10 This is not as dramatic as it sounds. The main difference between charges and other types of security interest – particularly legal interests like legal mortgages and pledges – is that the priority rules are different. Priorities are dealt with in part 8, and, as has been mentioned above, the distinction between legal and equitable interests has been retained and can therefore be used as a priority device to the extent it is thought appropriate.
- 11 The purpose of the Code is to simplify and clarify the existing law. Charges are ubiquitous, and that is the model which has been used. Legal mortgages are used commonly for assets such as land, ships and aircraft, and the key distinction here is that registration in the asset registry determines priority. That will not change.
- 12 The key distinction between pledges and charges is that the latter are generally registrable, and the former are not. This distinction is reflected in part 7, which is concerned with registration.
- 13 It would logically be possible to create a new form of charge which would sit alongside the existing security interests. But that would not simplify the law; it would complicate it. If we are to have a Code, we have taken the view that it needs to provide for one type of security interest.
- 14 The Code eschews formalities, but accepts that other legislation may impose them. In practice, security arrangements are written down, but we have not required this. The reasons are practical, as anyone having to deal in practice with the formal requirements for the creation of guarantees will understand. It also continues to allow chargors to grant informal possessory security.

Part 3: Charged assets

- 15 This part broadly reflects the existing law on charged assets, but it does make certain important changes to the current law.

- 16 There is an attempt (in section 12.3) to regulate when an asset which is received by the chargor after it enters into insolvency proceedings falls within the scope of a charge and when it is available to the insolvency officer. This will need discussion.
- 17 An attempt has been made to clarify, and sometimes to improve, some of the more technical aspects of the existing law. So, for instance, section 14 goes further than the current law by setting broad default rules on the extent to which a charge over an asset includes connected assets.
- 18 There is a specific section (section 15) which deals with receivables, which is broadly intended to reflect the current law.
- 19 One of things which we want to explore is the possibility of adding other sections in this part to deal with the particularities of various types of asset – for instance land or particular categories of goods and intangibles (such as registered land, ships and aircraft and intellectual property).
- 20 This part also contains rules to deal with contractual restrictions on charging assets. These are broadly intended to reflect the current law.
- 21 We considered whether it would be appropriate to tackle the issue of contractual restrictions on charging receivables. Because this is currently the subject of proposals for change under the Small Business, Enterprise and Employment Act 2015, we decided not to do so, but we have included some suggested drafting as an Annexure to this User Guide.
- 22 There is a tension under the current law between, on the one hand, giving effect to contractual restrictions on assignment which have been agreed by the parties and, on the other, allowing security to be created over valuable receivables. Our suggested wording in the Annexure deals with this problem in two ways. It allows a charge to be created even though there is a prohibition in the relevant contract. But it also makes it clear that this will not affect the rights of the counterparty to the contract. What the charge does is to give the chargee a proprietary interest in the event of the chargor's insolvency. This is something with which the counterparty should not be concerned. But, where the counterparty is concerned – for instance whom to pay, how much, and when – the existence of the charge does not affect the counterparty at all. It would be perfectly possible, as now, for the chargor to direct the counterparty to pay into an account with the chargee where the contract with the counterparty allows for such directions, but this would not affect, for example, set-off rights of the counterparty.

- 23 This is intended as a practical compromise solution to a problem which arises all the time in practice. It is put forward for discussion – to see if any consensus can emerge about how to deal with this important practical issue.

Part 4: Secured obligations

- 24 Secured obligations are drafted broadly to include any obligation or liability of any kind.
- 25 One issue to be considered is whether this should be restricted to monetary liabilities – not just primary obligations to pay debts of all kinds (including future and contingent debts) but also secondary obligations to pay damages. The question is whether it is practicable to secure an obligation which is ultimately to do something other than to pay money. In such a case, it is not possible to establish the extent to which the secured assets are required in order to discharge the secured liability. They would not be commensurable (to use an expression coined in relation to the law of set-off). When you come to enforce, how much do you enforce for?
- 26 In practice, one of the most difficult issues concerning secured obligations is the extent to which a charge granted to secure a particular facility will extend to that facility as amended in a fundamental way. This is ultimately a matter of interpretation, but section 19 attempts to establish a broad default rule (which can be contracted out of) that the charge does extend even to fundamental amendments. This is intended to benefit chargors as much as chargees. In our experience, the wish to avoid more documentation comes from chargors – because they would generally have to pay for it.
- 27 The extent of an “all moneys” clause is also a matter of interpretation, but section 20 contains another broad default rule (which can also be contracted out of) which is intended to give “all moneys” a broad meaning.

Part 5: The parties to a charge

- 28 The key point in part 5 is a limitation on the extent to which natural persons can create charges over their goods. The Law Commission is currently conducting a review of the Bills of Sale legislation, and this may therefore be overtaken by events. On the assumption that it is recognised that consumers should not be able to create security over absolutely all of their assets, the Code contains a suggested approach to charges over goods. Again, it is intended as a starting point for discussion.
- 29 The description of a chargee in section 24 reflects the current understanding and practice that the chargee can either be a creditor or a person (such as a trustee) who

holds the charged asset on behalf of the creditor; and this works well in practice. In the so-called “extended liens” case, as part of the Lehman Brothers litigation, Briggs J adopted a wider formulation. This has not been adopted because of the uncertainties which it might create, but it is something which is open for discussion.

- 30 It may be worth describing in the Code the default rules as to when, if a debt is transferred, the security transfers with it.

Part 6: The terms of a charge

- 31 The underlying principle must be that the parties should be free to determine the terms of their charge. The only exception should be consumer cases. This brief part therefore sets out skeletal default provisions, in the expectation that these will invariably be amended by agreement.

- 32 Section 27 preserves the concept of the equity of redemption, but does away with the doctrine of “clogs on the equity of redemption”, which is an unnecessary extension of the concept which can create practical problems in commercial transactions.

Part 7: Registration

- 33 It is generally accepted in the profession that the registration of charges is worthwhile and effective. The problem comes in trying to extend the current registration system from companies to other persons.

- 34 The approach which has been adopted under the PPSAs is that registration should apply to all chargors. This has an appealing logical simplicity, but it has meant the creation of new stand-alone registration systems, which can be complicated and expensive to establish and maintain.

- 35 The current company registration system works well in practice, and the Code has been built around this.

- 36 The starting point of the Code is that registration of charges is important in commercial transactions, and that it should be required unless there is a very good reason not to have to register.

- 37 But it accepts that what is required in a commercial context is not necessarily required outside it. A requirement for all individuals to register most charges they create is unlikely to be cost-effective, particularly as it could be applied to short term financial

transactions leading to a high volume of registrations against the tens of millions of adults in the UK, most of which, experience elsewhere suggests, will remain on the register long after all the secured payments have been made, making the register increasingly expensive to maintain and increasingly misleading for users. What is needed is to draw a line between commercial and consumer transactions; and to require registration only in relation to commercial transactions.

- 38 The simplest way to do that is to require registration by companies, and not by individuals (although charges created by individuals will continue to be registrable in the asset registries). The Code broadly follows this line, but adds certain other categories of person to a list of those who need to register. These include LLPs, companies incorporated by statute or by royal charter, partnerships, limited partnerships and sole traders.
- 39 The thought behind the Code is to enable partnerships, limited partnerships and sole traders to register at Companies House if they want to create a charge. What needs to be considered is whether the benefits which would be obtained from registration justify the cost of requiring it. But one of the key points here is that this would be an addition to an existing system of registration, not the creation of a wholly new one.
- 40 The registration system which is described in part 7 is based on the current system of registration at Companies House, with suggested improvements and simplifications.
- 41 There has been discussion of whether rent charges should continue to be registrable. If it were thought appropriate to exclude them, that could be dealt with in the Code.
- 42 Part 7 does one other thing. In section 37, it enables (but does not require) the registration of receivables financing agreements, such as factoring and invoice discounting agreements.
- 43 These are not treated in the same way as charges. Registration is not a requirement of validity. It would be voluntary system of registration which could be used by receivables financiers in order to improve their priority position (which is discussed under part 8, below). This is an issue which has been discussed for some time. The purpose of section 37 is to enable us to assess its practicality.
- 44 The Code is mostly concerned just with the law of England and Wales. But, since the registration provisions of the Companies Act apply throughout the United Kingdom, it

would be necessary to ensure that the changes are compatible with the laws in Scotland and Northern Ireland and acceptable in those jurisdictions.

Part 8: Priorities

- 45 The current priority rules in England are intractable, and there is a general consensus that they should be simplified and improved.
- 46 The problem with simplifying the priority rules is that it has to be done in relation to all types of interest in all types of property. A comprehensive reform of priority rules cannot be achieved within the context of Secured Transactions Code.
- 47 So what the Code tries to do is to deal with certain key priority issues which are relevant in relation to charges, whilst, at the same time, allowing the existing rules to apply where the Code does not.
- 48 The Code regulates the priority of charges amongst themselves, and also priorities between receivables financing agreements and between charges and receivables financing agreements.
- 49 One of the issues we have grappled with is the extent to which legal interests should continue to be given priority over equitable ones. Where the priority dispute is between a chargee and a third party which is not a chargee, the existing rules will inevitably apply, and the law/equity divide will therefore be relevant. But to what extent should it be preserved in the priority rules between chargees? We have inserted a Rule 4 which does preserve the law/equity divide in relation to financial collateral, but not otherwise. These are difficult areas, and we look forward to a discussion of them.
- 50 It also deals with the circumstances in which an outright purchaser of an asset will take free of a charge. This will generally be a matter of the interpretation of the charge itself. It will specify the extent to which the chargor has the ability to sell assets free from the charge. In a properly drafted charge, this will normally be all that is required.
- 51 But there will inevitably be cases where a purchaser will need to buy an asset from a company without checking the terms of the charge. A company cannot sensibly carry on business if its purchasers are always required to check its charges register before doing business with it.
- 52 In dealing with this problem, the Code draws on the well-known distinction between fixed and current assets. A person should generally be able to buy a current asset

from a company without checking what charges it has created. But, in the case of a fixed asset, the purchaser would be expected to check. The distinction is not always easy to draw, particularly because it depends so much on the business of the company concerned. But then it does reflect the realities of the commercial situation.

Part 9: Enforcement

- 53 In practice, most powers of enforcement are set out in the charge itself. The default powers of enforcement in legislation and case-law are complicated, confusing and out-of-date.
- 54 The Code assumes that powers of enforcement will continue to be set out in the charge documents, but it establishes default powers which are more in line with current commercial practices.
- 55 It also sets out the duties of those enforcing security, which are broadly intended to reflect the current position.
- 56 One issue for discussion is whether a system should be introduced to enable the chargee to retain the asset on enforcement if there are suitable protections for the chargor. Foreclosure is not available under the current law without a court order, although appropriation of financial collateral serves a similar purpose and does not require a court order. Is it possible to establish appropriate safeguards for the chargor to establish a general out-of-court procedure?

Part 10: Insolvency proceedings

- 57 It would be possible for the Code not to deal with insolvency proceedings at all. But, because security is rarely enforced outside an insolvency proceeding, it was thought important to refer to them, and to set out the key ways in which an insolvency proceeding impinges upon the enforcement of security.
- 58 Insolvency law currently draws a distinction between fixed and floating charges. The Code does not draw this distinction. Whether or not a purchaser takes free of the charge depends on the terms of the charge and the provisions of part 8 of the Code. The Code does not yet contain a provision to deal with what, if any, liabilities should rank ahead of charges on an insolvency. It is the subject of the Discussion Paper issued by the CLLS in February 2014.

59 The Code also raises the question of how to deal with the current claw-back provisions in section 245 of the Insolvency Act 1986. This only applies to floating charges, and would therefore need to be reconsidered.

Cross-border transactions

60 Cross-border transactions are very important in practice, and we think it is important that a Code should state the English conflict of laws rules on the validity of security.

61 The issues here are complex – not least the relationship with EU law – and it has been decided not to put forward drafting at this stage but first to see if it is possible to reach a consensus on what is both feasible and desirable.

62 The discussion will provide an opportunity to test the utility of the current rules and to see whether they can be improved. For instance:

- To what extent is the *lex situs* still an appropriate rule for goods?
- Is the law of the place of registration a better test for goods which are the subject of an asset registry?
- As a general principle, should the law governing an intangible asset be the law which determines the validity and priority of security over that asset?
- To what extent should failure to register a charge in the place of incorporation of a chargor affect security in other jurisdictions?

63 EU law impinges on this area, and any rules which are established would need to be compatible with the EU rules. We look forward to a discussion of these issues.

ANNEXURE

PART ●: CONTRACTUAL RESTRICTIONS ON TRANSFER

1 Scope of this part

- 1.1 This part ● applies to transfers of assets, not just to charges.
- 1.2 For this purpose, a transfer of an asset is:
- (a) the transfer of all or any part of the asset; or
 - (b) the creation of a proprietary interest of any kind over all or any part of the asset, by one person (the “transferor”) in favour of another person (the “transferee”), whether it is outright or by way of security.
- 1.3 A transfer of an asset therefore includes not only a charge, but also an assignment and a trust.

2 Contractual restrictions on transferring receivables

- 2.1 A transfer of a receivable is effective even if it is prohibited in the contract by which the receivable is created.
- 2.2 The transferee therefore obtains a valid proprietary interest in the receivable in spite of the prohibition. Subject to part ● [*Insolvency Proceedings*], that proprietary interest remains effective if the transferor enters into insolvency proceedings.
- 2.3 But, if it is prohibited by the contract, the transfer does not affect the rights, liberties, powers and immunities of the payer. The payer can deal with the transferor as if the transfer did not exist. In particular, the transferor cannot be required to pay a greater amount, or to pay to a different person or in any other way to pay on different terms than are provided for in the contract. On an insolvency, set-off will continue to apply as if there had been no transfer.

3 Contractual restrictions on transferring other intangible assets

- 3.1 Except for a transfer of receivables, the benefit of an intangible asset (for instance, a contract) cannot be transferred if it is prohibited by the terms on which the asset is created (for instance, the terms of the contract).

- 3.2 This is the case even if the prospective transferee is unaware of the restriction.
- 3.3 Whether or not the particular type of transfer concerned is prohibited by the terms of a contract is a matter of interpretation of the contract concerned. The question is whether it is the object common intention of the parties that a transfer of that type is prohibited.
- 3.4 If the terms of a contract do prohibit the particular type of transfer concerned, then:
- (a) except for any transfer of receivables, any purported transfer is, to the extent of the prohibition, invalid;
 - (b) the purported transfer is not, of itself, a breach of the contract by the transferor; and
 - (c) if the transferor has agreed to effect the transfer, the invalidity of the transfer may result in a personal claim by the intended transferee against the transferor for breach of contract.

4 Contractual restrictions on transferring other assets

- 4.1 The validity of a transfer is not affected by any other contractual restriction on transfer.
- 4.2 This is the case even if the transferee is aware of the restriction.
- 4.3 This does not affect any personal claim for breach of contract which the transferor may be liable for.
- 4.4 If the transferee takes the transfer with actual knowledge of a contractual prohibition on the transfer and it deliberately encouraged the transfer to breach that provision, the transferee is liable in tort for the loss suffered by the person in whose favour the prohibition was given. The transferee has no other liability of any kind (for instance, in tort or in equity) if it takes a transfer in breach of a contractual restriction of this kind.