

DISCUSSION PAPER: SECURED TRANSACTIONS REFORM

This paper has been produced by the Financial Law Committee of the City of London Law Society. Its purpose is to consider the current state of the law concerning secured transactions in England and to suggest how it might be improved.

Over the last decade and more, we have been involved in consultations on the reform of the law of secured transactions. The law concerning the registration of company charges is now in the course of being reformed, but the discussions have extended far beyond that topic to cover secured transactions generally and, indeed, certain types of outright transactions (such as sales of receivables).

This is therefore a good time to take stock of the current law concerning secured transactions and to see whether it can be improved.

The purpose of this paper is to identify those areas of the law which are in need of reform. We think it is important to do this first - before becoming too specific about possible solutions. We wish to encourage the discussion of the issues by interested parties, with a view to seeing if there is a consensus for reform in particular areas. If there is, we would hope that a broadly-based working party could take the issues further. At this stage, therefore, we have generally restricted ourselves to recommending areas for further discussion.

We have concentrated on security given in commercial transactions. Security granted by individuals raises very different considerations.

The paper is divided into seven parts. Part 1 contains a summary of our recommendations. Part 2 explains how we have approached the issues. The remaining parts discuss five key aspects of the law of secured transactions:

- Part 3: creation and registration;
- Part 4: enforcement and insolvency;
- Part 5: priorities;
- Part 6: cross-border issues;

- Part 7: alternatives to security (guarantees, set-off, reservation of title and outright sales).

There is a list of recommendations in Appendix 1. Appendix 2 contains information about the City of London Law Society and the working party of its Financial Law Committee which produced this paper.

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PART 1: SUMMARY

1.1 This Part contains a brief summary of our recommendations.

Creation and registration

1.2 Although there is a multiplicity of different types of security interest which are available under English law, this does not create material problems in practice. But, in the longer term, we do think it would be sensible to consider whether it is practicable to establish a single universal security interest - based on the charge - which could replace our existing security interests. The advantage of this approach would be that all aspects of the law relating to secured transactions could be set out in one place. This would make it more accessible to those involved in taking or granting security, including those from outside England who engage in cross-border financing. It could also result in useful clarification and simplification of the law. That is not to say that the law does not work well as it is. It does. But it would be a useful long-term goal.

1.3 One issue which does create problems in practice is restrictions on the assignment of contractual rights. These rights are important in practice. We recommend exploring the possibility of establishing a default rule which would give effect to the assignment whilst at the same time protecting the interests of the (obligor) counterparty to the contract.

1.4 The Government is presently in the process of finalising the reform of the law of registration of security, and we think that this should be allowed to settle down before anything further is done in this area. When it is time to consider this area again, one matter which is worth considering is the extent to which control over intangible assets should be an alternative to registration - although it should be stressed that this is a controversial topic, and one with an EU dimension.

Enforcement and insolvency

1.5 The main problem in this area is the necessity to draw a distinction between fixed and floating charges because proceeds of floating charges (but not of fixed charges) are made available to various other people before the chargee. The uncertainty which this creates is a major blot on English commercial jurisprudence, and we think it needs urgent examination.

1.6 Longer term, it would be useful to simplify the default enforcement powers of secured creditors (which are currently unclear and fragmented), although this is not a material problem in practice because enforcement powers are invariably set out in the security document itself. We also suggest that the rules concerning clogs on the equity of redemption could be simplified.

Priorities

- 1.7 The priority rules are more complicated than they need to be, but it is not always obvious what should replace them. It is not a material problem in practice, but we do think that in the longer term there should be a comprehensive review of the priority rules. This cannot just be done in relation to secured transactions. In order to make sense, it needs to deal with the priority rules for outright, as well as secured, transactions.

Cross-border issues

- 1.8 The key problem in relation to cross-border issues is the uncertainty surrounding many of the rules which determine the law which governs the validity and priority of proprietary interests (whether outright or by way of security). Although the rules which we do have are basically sound, the lack of case-law means that there is much more uncertainty than is desirable. A wholesale review of the law which determines the validity and priority of proprietary interests, whether outright or by way of security, would be welcome. This would need to be done in the light of EU initiatives in this area.
- 1.9 The EC Insolvency Regulation works reasonably well, but in the longer term we suggest that consideration should be given to clarifying those aspects of it which impinge upon secured transactions.

Alternatives to security

- 1.10 Guarantees are an integral part of many security packages. We regard section 4 of the Statute of Frauds 1677 as an unnecessary formality, which should be repealed.
- 1.11 Longer term, we would welcome the clarification and simplification of the law relating to guarantee protections. This is not a material problem in practice, because these protections are normally contracted out of in financial guarantees. But it would be sensible to clarify and simplify the default rules.
- 1.12 The law of set-off is crucial in many secured transactions. It generally works well, but we recommend certain (relatively minor) clarifications to make it work better.
- 1.13 We do not see that there is any merit in bringing reservation of title or similar devices into the ambit of the law on secured transactions - largely because they are not secured transactions.
- 1.14 In the longer term, we think it is worth exploring whether outright sales of assets such as receivables should be registrable for the purpose of priority.

PART 2: OUR APPROACH

What topics are covered?

- 2.1 We have considered security law as a whole. We do not think it sensible to restrict the discussion just to security over personal property. The same issues arise whether the charged asset is personal property or real property, and in practice the same security is frequently taken over both types of asset.
- 2.2 We have also considered insolvency law where it impinges on security. Many of the current issues concerning security arise as a result of insolvency legislation, and it is impossible to understand how security works in practice without understanding the effect of insolvency law on it.
- 2.3 In addition, we discuss guarantees and set-off. Although not strictly security, they are an integral part of the protection required by a secured creditor, and are used in conjunction with security in structuring transactions.
- 2.4 We also consider those outright transactions which serve a similar economic purpose to security - such as reservation of title and the outright sale of receivables. Unlike guarantees and set-off, these are not used in conjunction with security, but as alternatives to it. To what extent should they be treated as security?
- 2.5 We concentrate on commercial transactions and on security given by companies and LLPs. We do this because these are by far the most important secured transactions in practice, and because security given by individuals (particularly consumers) raises very different (and more difficult) issues.

What has been our approach?

- 2.6 We have approached the task of reviewing the English law of security by starting with the current law and measuring it against certain principles which we consider to be at the heart of a good secured transactions law. Those principles are discussed later in this Part. Our conclusions are based on our collective experience of applying the law in practice.
- 2.7 We have tried, as best we can, to look at the issue without preconceptions. It is for this reason that we have not thought it appropriate to use any other security law system (such as a Personal Property Security Act) as our benchmark. We have started with what we have at the moment, tested it against our principles, and drawn conclusions from that.
- 2.8 We have been commenting on proposals for the reform of the law of security for a number of years. But, for the purpose of this review, we have looked at the issues afresh. Our law of security is based on concepts worked out in England during the nineteenth century and adapted

subsequently. The Personal Property Security Acts are based on concepts adopted in the United States to meet its needs in the mid-twentieth century. What we need to do now is to create a law of security which meets the requirements of the twenty-first century.

- 2.9 We have looked at the law from the point of view both of those taking security and of those granting it. Very often, their views will be aligned, particularly where what is required is simplicity, speed and economy. But there are areas where the interests of creditors and debtors diverge, and we have approached these on the basis of our experience of advising both debtors and creditors on secured transactions, as well as advising operators of financial market infrastructure in or in connection with which secured transactions are executed.
- 2.10 In the interests of brevity, we do not describe the current law in detail. There are text books which do so, and we have assumed that those reading this paper will be familiar with the current law.
- 2.11 In certain areas covered by this paper, there are existing or prospective European laws that must necessarily inform or shape our analysis of a particular issue. This is particularly the case with reference to financial collateral and intermediated securities. Our review has proceeded with due regard to the influence of such laws on our domestic security law; and any reform of the legal framework must heed the pivotal role that English private law plays in global financing transactions.

The principles

- 2.12 We have had in mind four principles to guide us in determining both what is wrong with the current law and also how it can be improved. These principles are:
- Principle 1 - simplicity: security law should be simple.
 - Principle 2 - flexibility: security law should be flexible.
 - Principle 3 - freedom: parties should generally be free to structure commercial transactions as they wish.
 - Principle 4 - transparency: security should be transparent.

Principle 1 - simplicity: security law should be simple

- 2.13 In our view, all commercial law - including the law of security - should be as simple as is possible, consistent with the subject matter concerned.
- 2.14 So much of the law which we see in our everyday practice is over-complicated. This just increases cost and uncertainty.

- 2.15 The advantage of simplicity is that it breeds both clarity and certainty. And it makes the creation and enforcement of security both easier and cheaper than it would otherwise be.
- 2.16 What should be important is the legal substance of the transaction, not its form. Unnecessary distinctions and elaborations should be avoided; they simply lead to arbitrage, uncertainty and, ultimately, a lack of confidence in our security law.

Principle 2 - flexibility: security law should be flexible

- 2.17 One of the great advantages of English commercial law is that it has been flexible enough to adapt to changing commercial situations.
- 2.18 The best way to achieve flexibility is for the law to be written in as broad and universal a manner as possible, without undue formality or unnecessary distinctions, and to leave as much as possible to be agreed between the parties. This ties in with the next principle.

Principle 3 - freedom: parties should generally be free to structure commercial transactions as they wish

- 2.19 Freedom of contract is an essential element of the approach of English law to commercial transactions. The law of security is a part of the law of property, and therefore cannot simply be based on freedom of contract. But, to the extent that it is consistent with the other principles, we believe that parties should be free to structure transactions as they wish.
- 2.20 This assumes that we are dealing with commercial transactions, not consumer transactions. Consumers need protection, and so in consumer transactions freedom of contract can no longer be determinative.

Principle 4 - transparency: security should be transparent

- 2.21 The advantage of security is that it gives a secured creditor priority over other creditors. From the point of view of the other creditors, this can be seen as a disadvantage. We do not believe that the answer to this is to make security more difficult to create or to impose formalities on the process. That would simply increase costs. The availability of security should increase the amount of credit available.
- 2.22 In our view, the answer is to ensure that security is transparent (in other words, readily discoverable). If it is, creditors can make an informed assessment of the risks of dealing with debtors.

PART 3: CREATION AND REGISTRATION

- 3.1 The law of security is part of our law of property. It is concerned with the creation and enforcement of proprietary interests over assets in circumstances where the interest concerned does not confer outright ownership, but is intended to secure the discharge of a liability.
- 3.2 This Part is concerned with the question of how such proprietary interests are created. If a valid proprietary interest is created by way of security, it will, as a general principle, be effective in the debtor's insolvency proceedings. This is because the secured creditor's proprietary interest in the asset concerned will remove that asset from the insolvency estate of the debtor, and thereby enable the secured creditor to be paid from its proceeds of sale.
- 3.3 This is not an absolute truth. There are some insolvency rules which impinge upon the secured creditor's rights. These are discussed in Part 4. But, as a general principle, what is involved in the creation of security is the obtaining by the secured creditor of a proprietary interest in the debtor's assets.
- 3.4 This frequently involves two steps - the creation of the proprietary interest and its registration at Companies House.

Variety of types of security

- 3.5 Security can be created in a variety of ways, including by pledge, legal and equitable mortgage, fixed and floating charge and contractual possessory lien. In practice, pledges and contractual liens are only used in limited types of transaction. Legal mortgages are common in particular types of financing. Fixed and floating charges are ubiquitous.
- 3.6 This multiplicity of types of security interest does not create problems in practice. There are advantages and disadvantages of each type of security interest, and the parties have a choice of which one to use in the particular circumstances of their transaction and in light of the nature of the asset the subject of the security.
- 3.7 We nevertheless believe that we should investigate the practicality of establishing a single universal security interest.
- 3.8 What we have in mind is to describe, in a clear and straightforward way, the principles which would apply to a universal security interest. It would set out the way in which security can be created. It would explain the various ways in which security could be "perfected" - for instance by registration or possession or possibly, in relation to certain intangibles, control. It would provide rules to determine the priority of security interests. And it would set out default powers for the enforcement of security.

- 3.9 The advantage of doing this would be two-fold. It could clarify those parts of the law which are uncertain. And it would make the law more readily accessible than it is at the moment.
- 3.10 The disadvantage (as is the case with any codification) is the risk of setting the law in aspic. One of the great advantages of the common law is its adaptability to change, and a codification should not prejudice that.
- 3.11 **Recommendation 1: The practicality of establishing a single universal security interest should be investigated.**

Pledges and contractual possessory liens

- 3.12 In our experience, pledges are used in trade and commodity finance, but not to a great extent in other types of financing. Equally, contractual possessory liens have a limited use in certain types of securities financing where bonds and similar negotiable instruments or securities are physically and directly-held by a depository or custodian. The requirement for the creditor to obtain, and retain, possession of a tangible moveable asset (including a documentary intangible) restricts its utility to a relatively small number of cases.
- 3.13 The advantage of a pledge or possessory lien is the ability to take security without registering it at Companies House. Registration is unnecessary because the creditor has possession of the asset concerned, and therefore the security interest is sufficiently transparent. This is particularly useful in short-term financings.
- 3.14 If there were to be a universal security interest, provision should be made for possession to be an alternative to registration.
- 3.15 Because pledges and possessory liens are relatively rarely used in commercial transactions (and cause few problems in practice), there is very little modern case-law on the topic. Although the basic principles are clear and well-understood, an advantage of a statement of a single universal security interest would be to clarify the existing law. It would be possible to explain precisely what is required in order to pass possession to the creditor and thereby obviate the necessity for registration. For instance, it could be put beyond doubt that a pledge or possessory lien cannot be created by attornment by a debtor in possession, and it would be possible to clarify what is meant by a document of title, at least for the purpose of creating a security interest by way of transferring possession.

Mortgages

- 3.16 A legal mortgage involves the transfer of legal title to an asset to secure a liability. An equitable mortgage involves the transfer of equitable title to or in relation to an asset to secure a liability. In practice, equitable mortgages are rarely used intentionally except in the context of equitable assignments of contractual rights. An equitable mortgage has no real practical advantages over an equitable charge. The ancient remedy of foreclosure (which is available to mortgagees, but not chargees) is now in practice obsolete; and a recent amendment to the Financial Collateral Arrangements (No. 2) Regulations 2003 (the FCARs) makes the remedy of “appropriation” available to both a mortgagee and a chargee under a security financial collateral arrangement. In most cases, a person taking an equitable security interest is likely to take a charge rather than a mortgage.
- 3.17 A legal mortgage can only be taken over assets which are recognised as being transferable at common law or by statute. In practice, this means land, goods (including ships and aircraft), shares and debentures of companies, registrable intellectual property and what are sometimes referred to as “documentary intangibles” (i.e. intangibles the right to which is tied up in a piece of paper and can therefore be transferred by delivery and, if necessary, endorsement - such as negotiable instruments and bearer bonds).
- 3.18 This means that a whole range of valuable assets are incapable of being the subject of a legal mortgage - in particular, many types of intangible asset. And, in addition, a legal mortgage cannot be taken over future assets.
- 3.19 But, in practice, this is not a material problem. An equitable charge (or, indeed, an equitable mortgage) can be taken over intangibles and over future assets. The only real advantage of a legal mortgage is that it can give greater priority over other encumbrances. This is discussed in Part 4. The important point for now is that a debtor can create a valid equitable mortgage or charge over any type of asset, and it will be as effective in the insolvency of the debtor as a legal mortgage. Unless there is a competition with another encumbrancer, an equitable security interest is just as good as a legal security interest against the debtor, or in its insolvency.
- 3.20 If a universal security interest were to be established, the necessity to draw the distinction between legal and equitable security interests for priority purposes could be replaced by a new priority system. We discuss this in Part 4.

Charges

- 3.21 Charges are ubiquitous. They are easy to create - all that is required is an intention to create a present, immediate security over identified or identifiable assets. They can be taken over all types of asset, including future assets. And floating charges enable the debtor to deal with the charged assets in the ordinary course of business without prejudicing the existence of the security.
- 3.22 If there is to be a restatement of a universal security interest, we believe that it should be based on the charge.
- 3.23 There are few formalities for the creation of charges. One which can cause problems in practice is the requirement of the Law of Property (Miscellaneous Provisions) Act 1989 for both parties to sign a contract for the disposition of land. It used to be the case that only the grantor of the interest had to sign. It would be preferable if only the chargor had to sign the document, and not the chargee as well. Another formality (outside financial collateral arrangements governed by the FCARs) that can cause problems is section 4 of the Statute of Frauds - which has been held to apply to a third party charge over assets. We discuss this further in the context of guarantees in Part 7 of this paper.
- 3.24 As a general principle, formal requirements tend to create more problems than they solve. It is our preference to reduce them to the absolute minimum necessary. But, since formalities are not peculiar to the law of security, it is difficult to amend all relevant rules as part of a review of security law.

Secured obligations

- 3.25 A security interest is only as good as the liabilities it secures. If there are no secured liabilities (actual or contingent, present or future), the security is worthless.
- 3.26 There is no restriction on the ability of the parties to agree what monetary obligations are to be secured. What is secured depends on the intention of the parties, and that is established, in the normal way, from the secured obligations clause in the light of the documentation as a whole and in the context of the surrounding matrix of facts at the time the documents are entered into.
- 3.27 Where the facility is bilateral, security can be drafted on an "all moneys" basis; but security taken for a syndicated facility will generally only secure money owing under the relevant finance documents. Problems can arise when the finance documents are amended. Does the security extend to the revised documentation?
- 3.28 The answer depends on the interpretation of the secured obligations clause in the security documents. This will normally secure obligations owing under the finance documents as they are amended from time to time. The issue is whether a court would regard a substantially amended

facility agreement as an amendment to the old facility or, in reality, as a new facility. It is common for documentation to make it clear that the amendments which can be made include fundamental ones such as an increase in the size of the facilities and the alteration of the purpose of the facilities. But it is ultimately a question of interpretation as to whether the amended facility is covered by the secured obligations clause.

- 3.29 Although this can create problems in practice, we do not think that a change in the law will help. The law already enables any monetary obligation to be secured if it is practicable to do so. It is then simply a matter of drafting.

Restrictions on assignment

- 3.30 It is common for contracts to contain restrictions on assignment. The extent of these restrictions is a matter of interpretation of the contract concerned, but it is clear that the courts will give effect to them. A purported assignment which is made in breach of such a restriction is ineffective.
- 3.31 This does create material problems in practice, when taking security. This is because any security which is taken in a manner which is in breach of the terms of the restriction in question will be held to be ineffective.
- 3.32 We do not think that the answer is to invalidate such clauses. In our view, it is axiomatic that the parties to a contract can decide its terms, and therefore whether or not it can be assigned.
- 3.33 We nevertheless think that it is worth exploring whether it would be possible to legislate for the effect of restrictions on assignment. It might be possible to protect the (obligor) counterparty to the contract whilst at the same time enabling the assignor to create security in favour of a creditor.
- 3.34 The (obligor) counterparty wants to ensure that he only has to deal with his creditor (the assignor), and not with anyone else. The assignee wants to obtain a proprietary interest in the contractual right which is effective in the assignor's insolvency. We do not think that these two aspirations are necessarily incompatible. The law could make it clear that any purported assignment in breach of a restriction would not affect the counterparty's rights against the assignor, or impose on it any additional liabilities, whilst at the same time allowing the assignee to obtain a (passive) security interest over the contractual right.
- 3.35 We do not underestimate the difficulty of doing this, and it should doubtless be possible for the counterparty and his creditor to contract out of any such new rule, but we do think that it would be helpful to explore the way in which such a rule might work.
- 3.36 **Recommendation 2: The possibility should be explored of establishing a default rule concerning prohibitions on assignment which would enable a creditor to obtain a**

proprietary interest (whether outright or by way of security) whilst at the same time protecting the interests of the (obligor) counterparty to the contract.

Floating charges

- 3.37 In practice, one of the most difficult problems which affect lawyers taking security is the necessity to distinguish between fixed and floating charges. The necessity to do so mainly arises as a result of the requirement, in an insolvency, to pay some creditors out of floating charge assets, but not out of fixed charge assets. This problem is caused by insolvency law; and we therefore deal with it in Part 4, when we discuss enforcement and insolvency.

Registration

- 3.38 The registration of charges is the one area of the law of security which has changed significantly in recent years; and it will change again in April 2013.
- 3.39 The removal of the requirement to register against overseas companies was a welcome simplification of the law. The changes to be implemented in April 2013 are not yet in final form, but we hope that they will clarify and streamline both the identity of those charges which are registrable and the process of registration.
- 3.40 As a result of these changes, there may be little appetite for a further wholesale review of registration. But we have decided that a review of secured transactions would be incomplete without a consideration of the registration requirements. As a result, we have not only considered whether there are any changes which could usefully be made to the registration system, but we have also reviewed again the need for a registration system, and whether it can be justified.

Is a registration system necessary?

- 3.41 When we have been consulted on proposals for the reform of company charges, we have supported the retention of a registration system. This has been for two principal reasons. The first is that security should be transparent. The second is that it is very useful in practice.
- 3.42 We have already mentioned that it is relatively easy for a debtor to create security in favour of a creditor, and that we believe this to be an advantage. But that has to be weighed against the disadvantage to the debtor's other creditors that it can so easily create security and thereby prejudice them.
- 3.43 One response would be to make it more difficult to create security. This would be counter-productive for the reasons which have been discussed above. In our view, the better approach is to ensure that persons dealing with the debtor are aware - or can easily become aware - of the

existence of the security, and can therefore take an informed decision in relation to their dealings with the debtor.

- 3.44 The issues can be illustrated by the following example. D owes money to C. D is owed money by T. D writes to C saying that D holds a receivable owing by T on C's behalf until the debt owing by D to C has been repaid. C does nothing else to protect its position. D later enters into insolvency proceedings. Who is entitled to the money due from T - is it C, or is it D's insolvency officer?
- 3.45 This informal arrangement creates an equitable charge in favour of C. Under the current law, its validity depends on whether D is a company or an individual. If D is an individual, the security is valid. If D is a company, it is invalid because it has not been registered. Security over receivables is generally registrable against a company but is not generally registrable against an individual.
- 3.46 Which is the better outcome? Should it be possible for security to be taken in such an informal way, or should there be a further requirement that the security be registered?
- 3.47 From the point of view of D's unsecured creditors, there is much to be said for the view that the security should only be valid if it is registered. An informal arrangement between D and C should not prejudice D's other creditors unless they are aware of it or can easily find out about it.
- 3.48 Registration gives the creditor the ability to search the register and to discover whether any security has been created. In the absence of a registration requirement, a secret arrangement between the debtor and a creditor will adversely affect the rights of third parties in an insolvency.
- 3.49 The value of the registration process is that it allows security to be created informally but, at the same time, makes the security transparent to third parties in a straightforward way.
- 3.50 The other reason why we have been in favour of a registration system is the simple fact that, in practice, it works. In our experience it provides those dealing with the debtor with useful information.
- 3.51 The contrary argument is that we all know that debtors create security and, if we are thinking of dealing with a debtor, we can ask it what security has been created. We might also make enquiries of a relevant trusted third party, such as a custodian or account bank, though they might not necessarily tell the whole story. A charges register will tell us no more than we already expect.
- 3.52 For the purpose of producing this paper, we have reconsidered our view on the question of registration. Having done so, we are still of the view that registration should generally continue to be required.

Should the registration system be changed?

3.53 If security interests are to be registrable, there are a number of other questions:

- (a) What should be registrable?
- (b) How should registration be effected?
- (c) What should be the effect of non-registration?

3.54 These are all issues which have been the subject of consultation recently in relation to the amendments to the registration regime which will take place in April 2013. To some extent, our answers to these questions will depend on just how the new legislation is framed. We will therefore deal with these points briefly.

3.55 As far as registrable security interests are concerned, we believe that:

- the basic principle should be that all security interests should be registrable;
- there should be an exception for security interests where the creditor obtains possession of the assets concerned (i.e. pledges and possessory liens);
- apart from financial collateral (and subject to an issue concerning control which we discuss below), there should only be very limited exceptions to the registration requirement.

3.56 We believe that the process of registration should be as simple as possible, that it should be possible to register the charge document itself, and that the prescribed particulars should be kept to an absolute minimum.

3.57 We have considered whether it would be preferable to have a system of “notice filing” but, on balance, we do not believe that it would be preferable to the system to be introduced in April 2013. The advantage of notice filing is that the creditor can file a brief notice to cover a variety of intended transactions. Its disadvantage is that the information available is necessarily much more limited than it would be if the charge document itself were filed, and it would contain information about transactions which may or may not actually happen. In practice, we think that the more accurate and detailed information available from transactional filing is useful. And we do not believe that it is a problem in practice to register each transaction.

3.58 In the interests of clarity and simplicity, we believe that the effect of non-registration should be to render the security void for all purposes, but without affecting or accelerating the underlying secured liability.

3.59 Although it does not cause material problems in practice, we believe that the “twenty-one day invisibility period” should be abolished. This would be necessary if Companies House were to be used as a priority system, but the difficulties of doing this should not be underestimated. Priorities are discussed in Part 5.

3.60 The system of registration requires the registration of security interests, but not of outright interests (including title transfer arrangements). We have considered whether this creates any practical problems or whether there is any material difficulty in distinguishing between secured and outright transactions. We are not aware of any material problems in practice. Whether outright transactions should require registration is discussed in Part 7.

3.61 **Recommendation 3: Further discussion of simplification and clarification of the registration system should await the implementation of the April 2013 changes.**

Control

3.62 Traditionally, English law has only recognised one exception to the requirement to register security interests created by a company - that the creditor takes possession of a tangible moveable asset (including a documentary intangible). In recent years, the law has recognised a further exception - that the creditor obtains “control” over financial collateral.

3.63 We have considered whether control by the creditor should be an exception to the requirement to registration for intangible assets generally.

3.64 One reason for doing this is that control is already a factor in relation to security over financial collateral. If control is an alternative to registration in the case of financial collateral, is this an example of a potentially wider principle? If possession is an alternative to registration in the case of tangible assets (including documentary intangibles), should control serve the same function in relation to other intangible assets - or at least some of them?

3.65 The contrary view is that registration of security serves a very useful purpose, and that exceptions to it should be few and far between. If the creditor is in possession of an asset, the debtor is not, and no-one will be fooled. Can the same be said of control? And although the concept of possession of goods is well understood, there is considerable doubt about the meaning of control of intangibles.

3.66 We have not reached a conclusion on this issue. But, on balance, we believe that the possibility of using control as an alternative to registration should be discussed further.

3.67 **Recommendation 4: Consideration should be given to whether control of intangible assets or certain types of intangible asset, should be an alternative to registration.**

Individuals

- 3.68 It is generally accepted that the bills of sale legislation is ripe for reform. The current legislation dates back to 1878. The problem has been in deciding what to put in its place.
- 3.69 Our experience is predominantly concerned with corporate debtors, and we therefore approach this topic with caution.
- 3.70 The current bills of sale legislation makes it difficult for individuals to borrow on security over goods. As a consumer protection measure, that may well be the best outcome. We would expect there to be limitations on the ability of consumers to create security.
- 3.71 Whether there should be similar restrictions on unincorporated businesses is another matter. In theory, we can see that it might be sensible to treat unincorporated businesses differently from consumers. On the other hand, the registration system in relation to companies works well because each company has an individual registered number. Whether it would be possible to provide a registered number for unincorporated businesses needs to be considered. If it were practicable to do so, it might be possible to extend the company registration system to unincorporated businesses, as has been done with LLPs.
- 3.72 The advantage of the current system is the clear distinction between companies and individuals. Any change would require a distinction to be drawn between individuals which are consumers and those which are businesses. That is much more difficult to draw.
- 3.73 **Recommendation 5: Security granted by individuals raises different and more complicated issues. It does need to be reformed, but the nature of the reforms is much less obvious than for companies and it is less pressing in practice.**

PART 4: ENFORCEMENT AND INSOLVENCY

4.1 The ability to enforce security simply and cheaply is as important as its creation. Security is a means to an end, not an end in itself. Its value consists in the ability of the secured creditor to turn the security into money in order to repay the secured obligations. And this is as important in insolvency proceedings as it is outside them.

Powers of enforcement

4.2 Most security documents contain detailed provisions conferring various powers of enforcement on the secured creditor. These provisions are, generally, effective and, in practice, secured creditors have few problems in enforcing security outside insolvency proceedings.

4.3 In the absence of express provision in the security document, the creditor's powers of enforcement are much less satisfactory.

4.4 The current default powers of enforcement are unclear in many respects, they differ depending on the nature of the secured interest concerned and the nature of the asset which is the subject of the security, they contain methods of enforcement (such as foreclosure) which are rarely used in practice, and the restrictions on enforcement contained in the Law of Property Act 1925 do not reflect current practice.

4.5 We consider that a simplified set of default rules which would apply to all security interests over all assets and which would reflect current practice would be useful, not least because it would sweep away the necessity to consider a great deal of arcane case-law which is no longer of any practical relevance.

4.6 It would need to be clear that these default powers could be expressly or impliedly contracted out of in any particular case, thus giving the required degree of flexibility to the parties to shape the enforcement powers to the particular context of their transaction.

4.7 **Recommendation 6: The possibility should be explored of establishing a simplified set of default enforcement powers which would reflect current practice, and which would be capable of being modified by agreement.**

Clogs on the equity of redemption

- 4.8 When a debtor creates security over his assets, he retains an equity of redemption. This is an important right, but the courts have extended it in various ways which are less satisfactory. One such extension is that a provision in a secured transaction which purports to encumber the secured assets after the security has been redeemed is void. In particular, an option for the creditor to purchase the secured assets will be void if it is part of the mortgage transaction.
- 4.9 This can create practical issues, and we think it is worth exploring whether it would be possible to allow the creditor to have an option to purchase the secured assets whilst at the same time protecting the debtor. In this respect, we have noted the right of “appropriation” which is available to a chargee or mortgagee under a security financial collateral arrangement (subject to suitable safeguards provided by the FCARs).
- 4.10 **Recommendation 7: Consideration should be given to simplifying or clarifying the rules concerning clogs on the equity of redemption.**

Duties on enforcement

- 4.11 It is important that there should be clear and straightforward duties on secured creditors, receivers and administrators when enforcing security. Although not all the cases are easy to reconcile, there does seem to be a broad measure of agreement on what those duties are. The courts have had to weigh the interests of the creditor and the debtor. The creditor wants to be repaid as quickly as possible. The debtor wants to ensure that full value is obtained for the charged assets. The courts have had to strike a balance between these competing interests.
- 4.12 There may be some merit in attempting to codify these principles, but experience of attempting to do so in other areas has tended to indicate that to do so may restrict the flexibility of the courts to adapt the principles to meet changing requirements.
- 4.13 If there is to be a universal security interest, it will be necessary to codify the duties of those who enforce security. Such a codification should be drafted in broad enough terms to enable the necessary flexibility to continue.
- 4.14 It is also recognised that these are issues where chargors and chargees may have different expectations, and this needs to be taken into account when establishing the principles.

Insolvency

- 4.15 In practice, security is nearly always enforced against the backdrop of an insolvency process in relation to the debtor. This does cause problems for the secured creditor, but they are inherent in the tension between the law of security and insolvency law.
- 4.16 In certain types of insolvency procedure (most notably administration), the secured creditor is prevented from enforcing its security as a result of a moratorium. In all types of insolvency procedure, a secured creditor is at risk of the security being attacked under the claw-back provisions of the insolvency legislation. These risks are well-understood and, although improvements can always be made, we are not aware of any material issues in relation to them.
- 4.17 There is, however, one issue which does create substantial problems in practice - the distinction between fixed and floating charges.
- 4.18 Although it is relatively easy to state the test of when a charge is a floating charge, its application to the facts of any particular case involves a great deal of uncertainty. This is supported by the evidence of the conflicting cases concerning charges over book debts decided over the last thirty-five years.
- 4.19 The reason why the distinction has to be drawn is largely because of the requirements of insolvency legislation. Were it not for the fact that insolvency legislation requires certain liabilities to be paid out of floating charge realisations, but not out of fixed charge realisations, there would be very little need in practice to draw the distinction.
- 4.20 We recognise that it may be appropriate to require some liabilities of a debtor to be paid in priority to secured creditors in some types of case, but the problem with the current law is the uncertainty which it creates.
- 4.21 Under the current law, it is simply not possible to advise, with any degree of certainty, whether many types of security interest are fixed or floating. That does a great disservice to English law.
- 4.22 We assume that, at least to some extent, administrations will need to be funded out of assets which are the subject of security. The difficulty is to identify what those assets should be.
- 4.23 There are at least three possible approaches:
- clarifying the distinction between fixed and floating charges (particularly in relation to those areas not covered by the existing cases or where decisions have introduced uncertainty);
 - identifying particular classes of asset which would be available to the administrator (as is done in many of the PPSA jurisdictions);

- allowing administrators to use a percentage of all of the company's charged assets up to a fixed limit.

4.24 This is a very delicate issue, and would involve a material change to insolvency law. But we think it is worth exploring solutions to what is a running sore in our legal system.

4.25 **Recommendation 8: A clear principle should be established to determine (a) who, other than the chargee, should benefit from charged assets and (b) the identity of the charged assets concerned. It should avoid having to distinguish between fixed and floating charges.**

PART 5: PRIORITIES

- 5.1 The English priority rules are detailed and complicated. English law broadly divides assets into three types - land, goods and registered securities, and other intangibles - to which it applies different rules. These rules are then overlaid by those which regulate the priority of security interests which are registered at the asset registries, as well as by particular rules for floating charges and for tacking further advances.
- 5.2 There is a consensus that the rules are too complicated and are in need of reform. The problem is in establishing what should replace them. Most priority disputes involve two innocent parties, each of whom has been duped by the debtor; and there is often room for doubt as to which of the parties ought to suffer as a result. It would be naive of us to assume that we now have all the answers to issues which have perplexed judges in reported cases for more than three hundred years.
- 5.3 Because most priority issues involve fraudulent action on the part of the debtor there have been few cases in the last fifty years in which such issues have had to be resolved by the courts in the context of company security interests. So, although there is no doubt that the priority rules need to be simplified, priority issues are not, in practice, the main concern of those taking security. Fortunately, priority issues arise infrequently in practice.
- 5.4 One of the reasons why there are fewer cases now than there were in the nineteenth century is because of the advent of the registration of security interests both at asset registries and at Companies House. The asset registers determine the priority of security interests over those assets which they apply to - land, ships, aircraft and certain intellectual property rights. The register at Companies House is not a priority register but, in practice, it does enable a creditor to find out about prior security interests and act accordingly.
- 5.5 We have given thought to whether it would be practicable to turn Companies House into a priority system for charges and thereby to avoid changing the underlying priority rules, but we have concluded that this “sticking plaster” approach would not work.
- 5.6 We see no alternative to a root and branch overhaul of the priority rules. And because so many of the rules relate to outright interests as well as security interests, we consider that it is essential that this review extends to outright transfers as well as to transfers by way of security.
- 5.7 **Recommendation 9: There should be a review of the priority rules for outright and secured transactions in relation to all types of asset, with a view to providing a coherent and simpler set of principles to determine priority.**

The existing priority rules

- 5.8 The system ultimately proposed may sweep away many of the existing priority rules, but it is important to consider how the existing rules operate in practice, with a view to informing the debate about reform.
- 5.9 The starting point for any discussion of priorities is the “first in time” rule, and the main issue in practice is the extent to which that rule is overridden in particular cases. There are a number of circumstances in which this can happen:
- A *bona fide* purchaser of legal title to an asset can take priority over an earlier equitable interest.
 - In the case of debts and certain other intangibles, priority may depend on the date on which notice is given to the underlying debtor (the rule in *Dearle v Hall*).
 - Registration can have an impact on priorities either by determining priority (in the case of the asset registries) or by giving (actual or constructive) notice of a registered interest (in the case of registration at Companies House).
 - If the equities are not equal, priority can go to the person with the better equity.
 - There are particular rules relating to the priority of floating charges, which can have the effect of postponing them to fixed charges.
 - The rules on “tacking further advances” restrict the ability of a secured creditor to rely on his priority when he has notice of a subsequent security interest.
 - In some types of case, transactions which are connected are treated as one transaction for the purpose of priority issues (this is the basis of the “purchase money security interest”).
- 5.10 There is a great deal of law on these topics which cannot adequately be discussed in a paper of this kind. We have therefore drawn out what we consider to be the key issues in relation to each of these principles.

The *bona fide* purchaser rule

- 5.11 A person who, for value, acquires a legal interest in an asset will take the asset free from an earlier equitable interest in it of which he did not have actual or constructive notice at the time he took his interest.
- 5.12 One merit of this principle is that a creditor who takes the trouble to obtain a legal interest (rather than just an equitable one) is rewarded. But whether this is any longer a sensible justification for drawing the distinction between legal and equitable interests is open to doubt.
- 5.13 If the distinction between legal and equitable interests is to be abolished for priority purposes in relation to secured transactions, it must also be abolished in relation to outright transactions. It would not be sensible to retain the principle in some types of case, but not in others.
- 5.14 There is an additional complexity which results from the rule concerning tacking the legal estate (sometimes referred to as tacking *tabula in naufragio*). This is an exception to the basic principle that a person acquiring a legal interest in an asset will only take free of an earlier equitable interest in that asset if, at the time he acquired the legal interest, he did not have actual or constructive notice of the equitable interest. The rule gives a person priority if he is able to get in the legal estate subsequently. It has been abolished in relation to land, but not in relation to other assets.
- 5.15 Whatever happens in relation to the *bona fide* purchaser rule, it is suggested that the principle of tacking the legal estate should be abolished in all cases.

The rule in *Dearle v Hall*

- 5.16 The priority of transfers of debts and certain other intangible assets is, subject to certain exceptions, determined by reference to the time the transferee gives notice of the transfer to the underlying debtor.
- 5.17 The rule in *Dearle v Hall* has caused a great deal of controversy. But it does have a certain practical appeal. The person who owes the debt will get a good discharge by paying the debtor unless he has been notified of the transfer. Once a debt has been paid, it ceases to exist, and the priority rule recognises this fact. That is not to say that, in appropriate cases, it would not be possible for one creditor to trace the proceeds of the debt into the hands of another. But a simple rule that both priority and discharge depend on notice has something to recommend it.
- 5.18 One alternative method of priority would be to enable transfers of debts to be registered and for priority to be given to the person who registers first. This is not straightforward. Debts owing by companies could be registered at Companies House, but how would debts owing by individuals be dealt with? Would the benefits outweigh the costs of setting up a new register?

Registration

- 5.19 English law has two registration systems - asset registries and debtor registries.
- 5.20 The asset registries apply to land, ships, aircraft and certain intellectual property rights. The basic principle with all of these registries is that, as between two registrable dispositions, priority depends on the date of registration, rather than on the date of creation; and a registered disposition will take priority over a registrable, but unregistered, one.
- 5.21 In our experience, this principle works well in practice and provides certainty. But it is only practicable in respect of assets of a sufficient value that a person who wishes to acquire an interest in the asset would expect to have to search the register. It is impracticable to set up registries for assets of too low a value.
- 5.22 One question in relation to the asset registries is the position of a person who is actually aware of an unregistered interest, but then goes on the register. Should that person take priority over the early interest when he was aware of it when he acquired his interest? Or should the register be sacrosanct?
- 5.23 The other type of registration system is against the debtor, rather than the asset. In the case of companies, this involves the registration of charges at Companies House. Unlike the asset registries, registration at Companies House does not directly affect priorities. But, in practice, the registration of a charge at Companies House may give other persons (actual or constructive) notice of that charge, and thereby prevent them from relying on the *bona fide* purchaser rule or the rule in *Dearle v Hall*.
- 5.24 In practice, this has limited the number of priority disputes because persons intending to deal with the debtor are able to search the register. But it is an indirect method of dealing with priorities, and the question arises whether it would be more sensible to give registration at Companies House a direct effect on priorities by ranking registered interests at Companies House by reference to the date of registration.
- 5.25 If this were to be done, it would be necessary to adopt a priority notice system along the lines of that used at the Land Registry. We do not, however, underestimate the potential difficulties of making a debtor registry, entries on which do not constitute title to an asset, a priority register in a similar way to an asset registry.

Unequal equities

- 5.26 The principle that the first in time has priority, and also the *bona fide* purchaser principle, are both subject to an exception. They only apply if “the equities are equal”. If the equities are unequal, the person with the better equity will prevail.
- 5.27 There is a great deal of case law on this principle, although it is very rarely applied in practice these days.
- 5.28 There is much to be said for abolishing this principle.

Floating charges

- 5.29 The priority rules concerning floating charges are very different from those which apply to fixed charges. This follows from the very nature of a floating charge. Where the creditor has a fixed charge, the debtor is unable to dispose of it free from the charge, or create a proprietary interest over it ranking ahead of the charge, without the consent of the chargee. With a floating charge, however, the chargor is given the general prospective authority by the chargee to dispose of, or otherwise deal with, the assets which are the subject of the floating charge in the ordinary course of the chargor’s business free from the charge until it crystallises. As a result, a floating charge will generally rank behind a subsequent disposition of the charged assets (whether outright or by way of security). This is because the debtor has the general authority to create such interests in priority to the floating charge; and a limit on its authority is only effective if the person affected has (actual or constructive) notice of it.
- 5.30 The Law Commission has suggested that the default rule should be varied so that the implied authority of the debtor under a floating charge should be limited to making outright disposals, and that it should not extend to the creation of security. It also suggested that it would be possible for the parties to agree a variation of this default rule.
- 5.31 We consider that such an amendment to the law would be useful and would reflect the expectations of the parties to secured transactions. If such a change were made, the default rule would be that the chargor would have the prospective general authority to dispose of its assets outright in the ordinary course of its business, but not the authority to create security over them unless specifically authorised to do so in the floating charge document.
- 5.32 We therefore suggest that the priority of a floating charge should depend on its date of creation.

Tacking further advances

- 5.33 Once it has been established that one charge takes priority over another, it might have been expected that its priority would extend to all obligations secured by it, regardless of when they were incurred. If, for instance, a charge is created in favour of A to secure all money from time to time lent by A, and that charge ranks in priority to a charge then created in favour of B, it might be expected that A's charge will rank in priority to B's charge in respect of all money lent by A, whether before or after B's charge was created.
- 5.34 In fact, this is not the position. The basic rule (although it is subject to exceptions) is that money lent by B after A has become aware of B's charge will rank ahead of money subsequently lent by A.
- 5.35 This is a difficult rule to justify in practice. We consider that all restrictions on the tacking of further advances should be abolished. Once a person can establish that his charge has priority over another interest, that priority should extend to all obligations secured by the charge, regardless of when they are incurred. We believe that such a rule would be both simpler and fairer than the current law.

The purchase money security interest

- 5.36 Where a person acquires an asset on mortgage, the acquisition and the mortgage are treated as one transaction for the purpose of priority issues - the so-called "purchase money security interest". There are conflicting authorities as to whether a sale and lease-back should be treated in the same way.
- 5.37 We think it would be helpful to clarify the law on this point. If a series of events are in reality one transaction, they should be treated as one transaction for priority purposes.

PART 6: CROSS-BORDER ISSUES

Cross-border security

- 6.1 It is common for secured transactions governed by English law to have links with jurisdictions other than England. Issues arising in cross-border transactions may not necessarily be decided by the English courts, but it is important to have clear conflict of laws rules.
- 6.2 In practice, the main problem with cross-border transactions is the paucity of case law on the conflict of laws issues and therefore the difficulty of advising definitively.
- 6.3 In practice, three issues are frequently of importance:
- Which law determines whether the debtor and any guarantors has validly entered into the transaction?
 - Which law governs the contractual effect of the arrangements?
 - Which law governs the proprietary effect of the arrangements (i.e. whether or not the security is valid)?
- 6.4 Whether or not the debtor and any guarantors are bound by the transaction is an issue which extends far beyond secured transactions and, although there is merit in clarifying the rules, that falls beyond the scope of a review of security law.
- 6.5 Most contractual issues are governed by the Rome I Regulation. That sets out the principles clearly and, although there are some issues of interpretation which arise, we are not aware of any material problems in practice in relation to secured transactions.
- 6.6 The question which is of particular concern to us is which law governs the proprietary effect of the transactions. It is this which will determine whether or not the security is valid.
- 6.7 On the whole, we think that the principles which the English courts have established are sensible. The problem is that they are established by quite a small number of cases, and there is still a degree of uncertainty, particularly in relation to the extent of the exceptions to the basic rules. We also consider that, in the area of intermediated securities, the “place of the relevant intermediary” approach under existing and prospective laws on financial collateral, settlement finality and central securities depositories is not without difficulty.
- 6.8 The basic principle in relation to goods is that it is the *lex situs* of the goods at the time of the transaction which governs its proprietary effect. In principle, we believe that this is a sensible rule, although it is worth exploring alternatives in relation to security over both present and future assets. But there appear to be a number of exceptions to the rule the extent of which is by no

means certain. We believe it would be far better to have a clear rule to which there were few (and certain) exceptions.

- 6.9 In particular, the rules which apply to registered ships and aircraft should be clarified. It is generally accepted that it is the flag of the ship which governs the proprietary effect of the transaction, but there is little clear authority which determines this. In relation to aircraft, the position appears to be that it is the *lex situs* of the aircraft at the time of the transaction which determines its validity, regardless of the place of registration of the aircraft. We believe that this rule needs to be reconsidered.
- 6.10 In relation to intangible assets (other than shares, securities and intermediated securities), the English courts have decided that the effectiveness of an assignment of a contract is a matter for the governing law of the assigned contract. We believe that this is a very sensible rule, but not all European jurisdictions interpret Article 14(2) of the Rome I Regulation in the same way.
- 6.11 It is also important to provide clarity on the rules which apply to intangible assets which are not the subject of Article 14(2) of the Rome I Regulation. It would be helpful to have clear rules in relation to assets such as shares, intellectual property rights and intermediated securities. In the area of intermediated securities, European laws affecting financial collateral, settlement finality and central securities depositories favour the “place of the relevant intermediary” approach and have regard to the “location” of the place where the relevant account is maintained. If we were unconstrained by the UK’s European Treaty obligations, we would favour the law governing the account agreement approach put forward by the 2002 Hague Securities Convention. This is because, as a basic principle, we believe that the effectiveness of transfers of intangible assets should generally be decided by the law which governs the intangible asset concerned (that is, the law under which the asset is created).
- 6.12 We should also consider the extent to which it might be practicable to determine validity by reference to the governing law of the transfer.
- 6.13 One issue which the cases do not deal with is the question of the priority of competing interests. In our view, priorities should be determined by the same rule which determines the effectiveness of the interest. So if, for instance, there is a transfer of a tangible asset whilst this is in a jurisdiction, it should be the law of that jurisdiction which determines both the effect of the transfer and its priority in relation to earlier transfers.
- 6.14 **Recommendation 10: We should establish clear and simple conflict of laws rules to determine which law governs the validity and priority of proprietary interests (whether outright or by way of security) created over all types of asset used in commercial transactions.**

Cross-border insolvency

- 6.15 This is a broad topic, and there is a limit to what can be achieved solely in relation to secured transactions.
- 6.16 One issue which is of particular importance in relation to secured transactions is the effect of those parts of the EC Insolvency Regulation which relate to the effect of *in rem* rights, claw-back and set-off.
- 6.17 The conflict of laws rules applied by the English courts depend on whether the centre of main interests of the company concerned is within the EU or outside it. This makes for complication. Consideration should be given to adopting the same rules for companies whose centre of main interests is outside the EU as we do for those within the EU.
- 6.18 It might also be sensible to try to provide more clarity about where a company's centre of main interests is. In particular, is it possible to strengthen the presumption that a company's centre of main interests is the place of its registered office? This of course would need to be done at the EU level.
- 6.19 **Recommendation 11: Consideration should be given to clarifying those aspects of the EC Insolvency Regulation which impinge upon secured transactions.**

PART 7: ALTERNATIVES TO SECURITY

- 7.1 In practice, the effectiveness of secured transactions does not depend solely on the ability of debtors to create security interests over their assets. As important is the ability of a third party to assume liability for the debtor's obligations. Its importance in practice is largely a result of the way in which business enterprises are structured, and particularly the proliferation of companies within a group.
- 7.2 The extent of rights of set-off is also of great importance to many lenders.
- 7.3 A feature of the Law Commission's discussion of secured transactions was a discussion of transactions which have the same economic effect as secured transactions, but which do not actually create security. The issue here is whether these types of transaction should be subsumed within secured transactions. We discuss this issue at the end of this Part.

Guarantees

- 7.4 Most contracts can be entered into without formality. One exception is guarantees. Section 4 of the Statute of Frauds 1677 requires guarantees to be in writing, or evidenced by a memorandum in writing, and signed by the guarantor or its agent.
- 7.5 Although, in the normal case, these formal requirements do not create material problems, there are cases in practice where issues do arise. For instance, guarantees are sometimes issued under the SWIFT system, and there are concerns as to whether a guarantee given in this form has been signed by the guarantor.
- 7.6 Even in recent years, there have been cases where a person has made a promise for good consideration which the courts have been unable to enforce because it does not comply with the formalities. Formal requirements of this kind simply make it more difficult for a court to give effect to the parties' intentions. The requirements of section 4 are already disapplied in relation to security financial collateral arrangements under the FCARs.
- 7.7 It is clearly important that protections should be available in consumer transactions (and they are). But we can see no justification for requiring formalities in relation to guarantees given in business transactions.
- 7.8 **Recommendation 12: Section 4 of the Statute of Frauds 1677 should be repealed.**
- 7.9 A consequence of the one-sided nature of a guarantee is the various protections which the courts have developed for guarantors. Their effect is that most arrangements between a creditor and a debtor in relation to the guaranteed debt will render the guarantee ineffective unless the guarantor agrees to them.

- 7.10 In finance transactions, these rules are invariably contracted out of. But it would be useful if the underlying rules could be clarified and simplified. There is a great deal of case law, stretching back over two hundred years, some parts of which are difficult to reconcile with others.
- 7.11 In some types of case (such as an agreement to give time to the debtor), any action by the creditor releases the guarantor. In others (such as variations to the underlying contract), there will generally be a release, but not if the creditor can show that the variation is necessarily beneficial to the guarantor. In a third type of case (loss of security), the guarantor is only released if the creditor acted negligently.
- 7.12 The effect of the arrangement also varies depending on the type of case concerned. In some cases (such as an agreement to give time to the debtor or a variation of the underlying contract), its effect is to discharge the guarantor's liability completely. In others (such as loss of security), the guarantor is only discharged to the extent that it has suffered loss.
- 7.13 **Recommendation 13: There should be a clarification and simplification of the law relating to the discharge of a guarantor. The parties should continue to be able to contract out of any such rules.**

Set-off

- 7.14 Because contractual set-off is always available outside insolvency proceedings, the key issue is the extent of insolvency set-off.
- 7.15 In recent years, the rules concerning insolvency set-off have been clarified and improved, but there remain issues which still need clarification. For instance, the application of the administration set-off rules and their interplay with other insolvency law relating to the payment of post-administration liabilities owed by a counterparty to a company in administration give rise to legal uncertainties. A particular concern relates to the way in which set-off works in administration in the period between its commencement and the date when the administrator decides whether or not to give notice of intention to make a distribution to creditors. It may be difficult for a counterparty to judge during this period whether the administration set-off rules will come into play or whether it can rely on any pre-existing contractual or equitable rights of set-off available to it. There are also questions concerning how insolvency set-off operates alongside a close-out netting provision.
- 7.16 **Recommendation 14: There should be a clarification of the law of set-off in order to deal with the position in an administration in the period running up to a distribution being made and how insolvency set-off operates alongside a close-out netting provision.**

Reservation of title

7.17 The question here is whether there should be any change to the current rules relating to reservation of title, conditional sale, hire purchase and leasing. There seem to be two possible proposals. If they are “in substance” secured transactions:

- they are recharacterised as secured transactions for all purposes; or
- they require to be registered as if they were secured transactions.

7.18 We have, in the past, criticised proposals which would blur the distinction between the retention of ownership and the creation of security. We have reconsidered this issue, but still believe that it is a confusion to suggest that title retention is a form of security.

7.19 Security can only be created over an asset by a person who has an interest in the asset concerned. In the case of a title retention mechanism such as a lease, the person who obtains possession of the asset does not obtain any interest other than the right to possession, and therefore has no other interest over which it can create security. This is not a technical nicety. It goes to the very heart of the legal rights of the parties concerned.

7.20 We can see no reason why the parties’ legal rights should be overridden merely because the transaction may be said to have the same economic effect. This is not a case of making sure that the form of the transaction follows the substance. The substance of the transaction is that the person in possession of the asset has never obtained title to it and cannot create security over it.

Outright sales

7.21 The issue here is whether, if a company owns an asset such as a receivable and sells it outright:

- it should be recharacterised for all purposes as a security interest if it is “in substance” a security interest;
- it should be registrable if it is “in substance” a security interest; or
- it should be capable of being registered for priority purposes.

7.22 This is a different type of case from reservation of title. Here, the company concerned does own the asset and deals with it.

7.23 We can see no justification for recharacterising the transaction as something which it is not.

7.24 There may be some justification for requiring registration as a condition of the validity of the assignment of some assets in some cases, but the problem comes in trying to define which types

of assignment fall within the regime and which do not. The PPSA systems require the registration of all assignments except those specifically excluded. This seems to come at the problem from the wrong end. On balance, we cannot see a compelling reason for adopting this approach.

7.25 This leaves the question whether a registration system would be appropriate to determine priorities for outright transfers of receivables as well as secured transactions. This is something which we believe should be considered as part of the priority discussion described in Part 5 of this paper.

7.26 **Recommendation 15: Consideration should be given to establishing a register of outright transfers of certain types of asset, such as receivables. Its purpose would be to regulate the priority of those transfers.**

APPENDIX 1: LIST OF RECOMMENDATIONS

Creation and registration

- 1 The practicality of establishing a single universal security interest should be investigated.
- 2 The possibility should be explored of establishing a default rule concerning prohibitions on assignment which would enable a creditor to obtain a proprietary interest (whether outright or by way of security) whilst at the same time protecting the interests of the (obligor) counterparty to the contract.
- 3 Further discussion of simplification and clarification of the registration system should await the implementation of the April 2013 changes.
- 4 Consideration should be given to whether control of intangible assets, or certain types of intangible asset, should be an alternative to registration.
- 5 Security granted by individuals raises different and more complicated issues. It does need to be reformed, but the nature of the reforms is much less obvious than for companies and it is less pressing in practice.

Enforcement and insolvency

- 6 The possibility should be explored of establishing a simplified set of default enforcement powers which would reflect current practice, and which would be capable of being modified by agreement.
- 7 Consideration should be given to simplifying or clarifying the rules concerning clogs on the equity of redemption.
- 8 A clear principle should be established to determine (a) who, other than the chargee, should benefit from charged assets and (b) the identity of the charged assets concerned. It should avoid having to distinguish between fixed and floating charges.

Priorities

- 9 There should be a review of the priority rules for outright and secured transactions in relation to all types of asset, with a view to providing a coherent and simpler set of principles to determine priority.

Cross-border issues

- 10 We should establish clear and simple conflict of laws rules to determine which law governs the validity and priority of proprietary interests (whether outright or by security) created over all types of asset used in commercial transactions.
- 11 Consideration should be given to clarifying those aspects of the EC Insolvency Regulation which impinge upon secured transactions.

Alternatives to security

- 12 Section 4 of the Statute of Frauds 1677 should be repealed.
- 13 There should be a clarification and simplification of the law relating to the discharge of a guarantor. The parties should continue to be able to contract out of any such rules.
- 14 There should be a clarification of the law of set-off in order to deal with the position in an administration in the period running up to a distribution being made and how insolvency set-off operates alongside a close-out netting provision.
- 15 Consideration should be given to establishing a register of outright transfers of certain types of asset, such as receivables. Its purpose would be to regulate the priority of those transfers.

APPENDIX 2: THE CITY OF LONDON LAW SOCIETY

The City of London Law Society represents approximately 15,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

This paper has been produced by a working party of the Financial Law Committee of the City of London Law Society. The members of that working party are:

Richard Calnan - Norton Rose LLP (Chairman of the Working Party)

John Davies - Simmons & Simmons LLP

Matthew Dening - Sidley Austin LLP

David Ereira - Linklaters LLP

Mark Evans - Travers Smith LLP

Kate Gibbons - Clifford Chance LLP

Dorothy Livingston - Herbert Smith Freehills LLP

John Naccarato - CMS Cameron McKenna LLP

Simon Roberts - Allen & Overy LLP

Nick Swiss - Eversheds LLP

Matthew Tobin - Slaughter and May

Geoffrey Yeowart - Hogan Lovells International LLP