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INTRODUCTION

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A. Scope of book

1.01 **Proprietary security and 'quasi-security' over personal property** This book is about proprietary security taken by creditors from debtors to support the repayment of loans or, much less frequently, the performance of other obligations. The security will normally take the form of a pledge, mortgage, or charge over the debtor's property. The book also deals with a number of transactions that on a traditional analysis do not involve the taking of security but that have a similar economic function, in that a party that provides credit retains property rights over assets that in practice are being purchased by the debtor with the credit provided: for example, goods that are leased to the debtor for their economic lifetime on terms that require the debtor to pay their full cost plus the cost of the credit supplied. It will be seen that these transactions involve what is often called 'vendor credit' as opposed to 'lender credit'. These devices that are 'equivalent' to security we term 'quasi-security'. The book deals also with the outright sale of 'receivables', i.e. debts (typically 'book debts')[1] that are due to the debtor. If these debts are assigned to, for example, a factor in exchange for an immediate payment at a discounted rate, and the factor then collects the receivables from the various 'account debtors' when the debts fall due, this too may be seen as functionally similar to lending on the security of the receivables. The equivalent of security may also be produced by a host of other contractual devices, such as priority agreements, contractual set-off and liens

[1] See para 7.02 et seq.

over sub-freights.[2] In the interest of a comprehensive treatment of a complex subject, these too must be included.

1.02 **Companies, unincorporated business debtors, and consumers** The debtors who feature in the cases in the book, and to whom many of the statutes dealt with in the book apply, will most frequently be company debtors. Traditional forms of security over personal property are far more commonly created by corporate debtors than by unincorporated business debtors (such as a sole trader or partnership) or by 'consumers' who borrow for purposes that are not connected to a business.[3] In part, this is because current law makes it difficult and risky for creditors to take effective mortgages or charges over the personal property of unincorporated business debtors or consumers. In contrast, unincorporated business debtors regularly sell their receivables, and both they and consumers regularly enter into 'quasi-security' transactions. Transactions entered into by non-corporate debtors are therefore also covered in the book, though a full treatment of consumer credit is left to more specialist works.[4]

1.03 **'Proprietary' as opposed to 'personal' security** This book deals only with proprietary security, as opposed to personal security of the sort represented by guarantees and by instruments such as performance bonds and standby letters of credit.[5] Personal guarantees are often closely allied with proprietary security, as where the directors of a debtor company provide personal guarantees in addition to the proprietary security taken from the company itself.[6] Although the book does not deal with personal security it does, as stated above, deal with a number of devices that, not unlike personal security, have an economic effect akin to the grant of proprietary security.[7]

1.04 **Security over personal property** Furthermore, this book does not deal with all cases of proprietary security but rather is limited to security over personal property, which can be understood for present purposes as all forms of property other than land. Nevertheless, the distinction between security over personal property and security over land is less clearly pronounced in English law than the general difference between personal property law and land law. This is because of the law and practice of security in the case of company debtors. A debenture or instrument of charge executed by a company debtor will frequently deal with security over both the land and the personal property of the company. Moreover, that instrument of charge as a whole will need to be registered under section 860 of the Companies Act 2006 and not just so much of it as relates only to the debtor company's personal property. So far as the company's land is concerned, it will be advisable (and in order to create a legal mortgage over land, now essential)[8] to register with the Land Registry.[9] The difficulty

[2] See ch 8.
[3] For a discussion of bills of sale granted by individuals, see ch 11.
[4] R Goode, *Consumer Credit Law and Practice* (2001, Looseleaf); A Guest and M Lloyd, *Encyclopedia of Consumer Credit Law* (1975, Looseleaf).
[5] The book also does not cover credit insurance and devices, such as credit default swaps, that serve the cause of insurance without being insurance.
[6] Leading works on personal security include G Andrews and R Millett, *Law of Guarantees* (5th edn, 2010); J O'Donovan and J Phillips, *The Modern Contract of Guarantee* (2003). A briefer account of suretyship will be found in *Chitty on Contracts* (30th edn, 2008), ch 44.
[7] See chs 7-8.
[8] Cf para 8.20.
[9] The same is true of other assets for which there are specialist registers, such as registered aircraft and ships and some forms of intellectual property. See para 9.24.

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of separating security over land and security over personal property is evidenced in other cases too. For example, before an administrator may be appointed out of court and sent in to enforce security taken from a defaulting company,[10] it must be demonstrated, *inter alia*, that that security is over the whole or substantially the whole of the company's property.[11] This quantitative test compels in its application a cumulation of the company's real property (land) and its personal property. The law of personal property and real property is also closely interwoven in the area of mortgages, where so much authority is derived from cases dealing with land.

1.05 **Secured debt rather than 'equity'** The book deals with security for loans. For a business, debt finance is an alternative to inviting investment from shareholders or partners, who will become part-owners of the business. When long-term financing is required, so-called 'equity financing', as well as various forms of hybrid finance that bridge the difference between debt and equity, will often be an alternative to debt financing, but the latter may still be used; short- and medium-term finance is normally obtained by borrowing.[12] This book deals only with secured debt-financing and not with equity finance and hybrid finance.

B. Reasons for security

Theory and practice

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1.06 **Theoretical insights** The practical starting point with security is to ask why security is taken by creditors.[13] In the voluminous American literature,[14] however, the theoretical focus is largely placed on the reasons why debtors grant security. This latter approach is closely tied to a broader concern with the raising of capital and with the division between equity and debt finance, arising out of the theory that, in a perfect market, a company debtor is indifferent to whether it raises capital by borrowing or by issuing shares since the cost to the company is the same.[15] This same body of literature also follows economic assumptions that credit is cheaper if security is given, because the risk of default in the case of security is offset, at least in part, by the creditor's enforcement of its security rights over collateral belonging to the debtor company. The literature also speaks to the 'puzzle' of secured credit in that, once obtained at a price discounted by the provision of security, it pushes up the cost of borrowing on a later, subordinated basis. It is by no means certain that, in practice,

[10] Or an administrative receiver in those remaining cases where an administrative receiver may still be appointed. See para 18.56.

[11] See para 20.67.

[12] For a discussion of debt finance, see E Ferran, *Principles of Corporate Finance Law* (2008), ch 11; L Gullifer and J Payne, *Corporate Finance Law* (2011), chs 7–8.

[13] See *British Eagle v Cie Nationale Air France* [1975] 2 All ER 390; *Re Ehrmann Bros* [1906] 2 Ch 697.

[14] See, for example, T Jackson and A Kronman, 'Secured Finance and Priority among Creditors' (1979) 88 Yale Law Journal 143; A Schwartz, 'A Theory of Loan Priorities' (1989) Journal of Legal Studies 209; R Scott, 'A Relational Theory of Secured Financing' (1986) 86 Columbia Law Review 901; SL Harris and CW Mooney, 'A Property-Based Theory of Security Interests' (1994) 80 Virginia Law Review 2021; L LoPucki, 'The Unsecured Creditor's Bargain' (1994) 80 Virginia Law Review 1887; H Kripke, 'Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact' (1985) 133 University of Pennsylvania Law Review 929; R Mann, 'Explaining the Pattern of Secured Credit' (1997) 110 Harvard Law Review 626. There is a very helpful summary of this literature in G McCormack, *Secured Credit under English and American Law* (2004), ch 1.

[15] The so-called Modigliani-Miller indifference theory.

a precisely calculable interest rate spread separates the cost of secured and unsecured credit. In addition, empirical evidence shows that the average recovery of secured creditors in the event of default and insolvency is very significantly less than the amount of capital and interest remaining unpaid.[16]

1.07 **Practical matters** A more practically orientated approach observes that debtors grant security because creditors require them to do so. It is more a case of creditors insisting upon security. There are some debtors powerful enough to resist the grant of security. The Law Commission has reported that well-established public companies are often able to borrow on an unsecured basis.[17] However, many smaller enterprises can obtain credit on significantly better terms, and sometimes can only obtain it if the borrower is able to offer security to the lender.[18] There has also been a change in the pattern of secured lending in the last century or so, from the issue of transferable secured debentures to the investing public[19] to advances from banks and syndicates of banks. Increasingly, however, lending is being secured against individual assets or an asset stream, especially receivables, rather than against a debtor with a range of assets. It is therefore the asset rather than the debtor that is the primary focus of risk assessment.

1.08 **Other motives for taking security** Protecting its interests in the event of the debtor's insolvency is not the creditor's only possible motive for taking security. From the creditor's point of view, security, when allied to enforcement rights often operative without recourse to the courts, gives the creditor the opportunity to take speedy measures to abate future losses. A secured creditor, moreover, is able to control the affairs of the debtor at critical moments and is equipped with the means to monitor the affairs of the debtor. Control and monitoring needs can also be served in unsecured loans by detailed financial covenants, coupled with rigorous events of default clauses that permit the creditor to call in the loan in the case of a breach of covenant or the occurrence of an insolvency-related event. Before the Enterprise Act 2002, which limits the rights of the holder of a floating charge to appoint an administrative receiver to run the company,[20] it was common to take a so-called 'light-weight' floating charge primarily to give the creditor this opportunity to take control of the debtor's affairs.[21] The appointment of an administrator out of court by a secured creditor makes the same case for a light-weight floating charge, but, as we shall see, restrictions introduced recently by the courts on the taking of fixed charges over book debts[22] will ensure in many cases that the floating charge is not light-weight after all.[23]

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[16] See J Armour and S Frisby, 'Rethinking Receivership' (2001) 21 Oxford Journal of Legal Studies 73, 96, referring to a survey conducted by the Society of Practitioners of Insolvency, showing that the average return to secured creditors is 37 per cent and that only 18 per cent of secured creditors receive payment in full.

[17] There are other reasons for not taking security. Some creditors are involuntary creditors, for example, tort claimants.

[18] Law Commission, *Company Security Interests* (Law Com No 296, 2005) (see further para 23.12), para 1.2. The Report pointed out that even public companies frequently make use of forms of security in particular situations, and that secured financing is a crucial feature of financial markets: ibid.

[19] These have apparently fallen into disuse: See para 23.28.

[20] See para 20.68.

[21] See further para 20.67.

[22] See further para 6.106 et seq.

[23] For the priority consequences of this in terms of liquidation and administration expenses, preferential creditors and unsecured creditors, see ch 20.

Security and insolvency

Insolvency advantages of security A more compelling reason for the taking of security, however, is that it separates secured from unsecured creditors in the event of the debtor's insolvency. The latter creditors, subject to exceptional cases, receive on average a very modest dividend when the debtor's estate is distributed by a company liquidator or a trustee in bankruptcy. Indeed, most of them have, until recently at least, not received a dividend at all.[24] Secured creditors, however, do not have to submit a proof of indebtedness to the liquidator or trustee and can avail themselves of their security rights before the estate is distributed.[25] Where the security is insufficient, they may prove for the balance of the debt.[26] Apart from the same exceptional cases again, the estate of the debtor is defined by what remains after the secured creditors have enforced their security.[27] So far as the security is insufficient to repay the creditor, the creditor is free to submit a proof for the unpaid balance.[28] This powerful reason for taking security is fortified by the creditor-friendly way in which English law allows security to be taken and by the relative inexpensiveness of taking security. **1.09**

Enforcement despite insolvency Another feature of the intersection of security and insolvency merits consideration here. It is not just a case of security defining the scope of the debtor's unencumbered estate. In addition, the secured creditor is able to enforce its security without hindrance from the debtor's insolvency representative, whose powers of intervention are in practice limited to waiting on the sidelines until the secured creditor's rights have been enforced.[29] Furthermore, it is a marked feature of the English law of security that it allows for security over future property of the debtor to such an extent that it catches property falling in after the commencement of insolvency proceedings.[30] **1.10**

Protection by other devices

Contractual devices for the protection of creditors Those extending credit may also use other consensual devices giving limited protection against non-payment by the debtor, although they do not involve the transfer or retention of title. Examples are contractual set-off, negative pledge clauses, flawed asset clauses, and subordination agreements. The extent to which these devices are effective if the debtor is insolvent has been the subject of some debate and is considered below.[31] However, where the debtor's credit rating is good, or where cross-border enforcement of security is problematical, these devices are often preferred to secured lending. There are also non-consensual rights that give some protection, such as the right of set-off, which, when it exists, gives extensive protection in insolvency.[32] **1.11**

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[24] In the past, the recovery amount has been popularly stated as lying within the 2–5 per cent range. The new rights granted to unsecured creditors under s 176A of the Insolvency Act 1986 as amended (see para 20.24 et seq) should ensure that in most cases there will be at least some dividend for all unsecured creditors. Moreover, the average recovery may now be higher than stated in the past.

[25] In the case of floating charges, this is not possible because of the prior rights of preferential creditors (ss 40 and 175 and Sch B1 para 65 Insolvency Act 1986) and, to a limited extent unsecured creditors (s 176A of the Insolvency Act 1986).

[26] Insolvency Rules 1986, r 4.88(1).

[27] Insolvency Act 1986, s 283.

[28] Insolvency Rules, r 4.88.

[29] See para 20.02.

[30] *Re Lind* [1915] 2 Ch 345; *Re Margart Pty Ltd* (1984) 9 ACLR 269 (NSW).

[31] See para 8.86 et seq.

[32] See para 8.36 et seq.

C. The contribution of equity

1.12 **The flexibility and reach of security under English law** A particular characteristic of the English law of security is its flexibility, evident in the way that the assets secured may be identified in general terms.[33] First, security is not confined to identifiable assets that are owned by the debtor at the time the security is taken but can take effect over assets that the debtor acquires in the future ('after-acquired property') without a further act of transfer by the debtor. Secondly, it is possible to take a present security over assets that are changing from time. This allowed for the taking of a so-called 'floating charge' over the entirety of a company's undertaking. Both developments occurred in the courts of equity in the nineteenth century.

1.13 **Future assets and assignment** The facility with which security can in English law extend to future as well as to existing assets is one of its most distinctive features, as well as being one of the outstanding achievements of the courts of equity.[34] The common law did not, as such, prohibit the taking of security over future assets, but it insisted on a fresh conveyance for each asset coming into existence,[35] an impracticable requirement in the case of revolving and future assets. The common law, moreover, did not recognize the assignment of intangible assets such as debts. Equity, on the other hand, did not require a fresh conveyance but rather treated future assets as being automatically transferred or encumbered once they came into existence.[36] The assignment of intangible rights was also an equitable creation.[37] Consequently, in equity, a debtor was able to raise finance on the basis of an ever-changing asset base such as present and future book debts. With the invention of the floating charge by equity draftsmen and courts, debtors were able to treat their entire undertakings as a single asset that could be the subject of a flexible, unified security agreement. This same unitary character of the English law of security persists today, in contrast with certain continental systems of law that have created separate compartments of different types of security (and quasi-security) device. Nevertheless, for reasons that will be developed in the remaining chapters of this book, the single floating charge has been superseded in fact by a combination of separate fixed charges over as many different assets as can support a fixed charge, together with a residual floating charge that sweeps up all assets that escape the row of fixed charges. As stated above, changes in the law restricting the freedom with which creditors can take fixed charges[38] have accorded a more expansive role to the floating charge, a device whose demise had previously been forecast in some quarters.

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1.14 **Freedom now coupled with protection later** This combination of fixed and floating charges gives the debtor freedom to continue to trade in the ordinary way, disposing of stock-in-trade and other smaller items without having to obtain the creditor's consent, except if it wishes to dispose of items (for example, a major piece of capital equipment) that the parties have agreed should be subject to a fixed charge or a reservation of title. If this flexibility to

[33] This same advantage is to be found in reformed personal property security regimes such as those in the United States, Canada and New Zealand: See paras 21.17–21.19.
[34] See ch 6.
[35] *Lunn v Thornton* (1845) 1 CB 379, 135 ER 587.
[36] *Tailby v Official Receiver* (1888) 13 App Cas 523. See further para 6.13.
[37] See further para 7.72 et seq.
[38] See further para 6.106 et seq.

allow the debtor to carry on its ordinary course of business were not possible there would be serious risks to the creditor, since it cannot effectively wait until things start to go wrong and then look for security or title transfer. Taking security after a loan has been advanced, because of a subsequent decline in the financial fortunes of the debtor, is not a straightforward matter. It is not the law of contract that creates difficulties in the way of enforcing promises to grant security for an existing loan advance: the creditor's forbearance from enforcing the loan at the request, sometimes implied, of the debtor, amounts to sufficient consideration for this purpose.[39] Rather, the difficulties in the way of the creditor arise out of the law's requirement that solidarity amongst unsecured creditors be preserved in the run-up to insolvency proceedings. This is why security may, for example, be open to challenge as an unlawful preference if granted in a defined period before the commencement of insolvency proceedings.[40] The purpose of the law here is to keep intact the company's assets so that they remain available to unsecured creditors as the beneficiaries of a deemed trust[41] once the debtor's insolvency regime supervenes. But security that is taken well before the debtor's insolvency, even if it leaves the debtor free to trade in most of its assets, will not normally be open to challenges of this kind.[42]

1.15 **Floating charges and unincorporated debtors** The freedom to create floating charges over all a business's assets is limited, however, to debtors that are companies.[43] This is because charges over many forms of personal property (including most types of goods) created by unincorporated debtors (whether sole traders, partners, or individuals) are subject to the Bills of Sale Acts 1878–1891.[44] These effectively prevent charges from being granted over such assets if the debtor does not own them at the time.[45] It is possible for unincorporated debtors to create floating charges over personal property that falls outside the scope of the Bills of Sale Acts,[46] and it is thought that they quite commonly give floating charges over shares and similar types of investment property, but a floating charge over the assets of an unincorporated business as a whole is normally not possible.[47]

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D. Categories of security interests in English law

1.16 **Pledge, contractual lien mortgage, and charge** English law is flexible in its approach to the taking of security but in one matter it is somewhat formalistic. That matter concerns the different types of security available in English law. Apart from security arising by operation of law, such as common law and equitable liens, and certain statutory rights akin to liens, English law recognizes but three types of security interests properly so called,[48] namely, the

[39] *Alliance Bank v Broom* (1864) 2 Dr & Sm 289; *Re MC Bacon Ltd* [1990] BCLC 324.
[40] See Insolvency Act 1986, ss 239–41, 340–42; *Re MC Bacon Ltd* [1990] BCLC 324.
[41] *Ayerst v C&K (Constructions) Ltd* [1976] AC 167.
[42] See para 20.04 et seq. But note the priority given to some creditors over floating charges, para 1.28. See also Insolvency Act 1986, s 245, which avoids some floating charges before the onset of insolvency.
[43] And now limited liability partnerships: see para 8.03.
[44] See para 10.03 et seq.
[45] See para 11.34.
[46] See further paras 11.25–11.28.
[47] For criticism of this see para 23.73.
[48] See further discussion para 4.04.

pledge, the mortgage and the charge.[49] It should not be thought, however, that English law is deficient in this respect, since those three securities are wide enough to cater for the creditor's needs, are broadly available, and in any event can be supplemented or substituted by devices akin to security, so that no new type of security is needed to fill any gaps.

1.17 **Pledges** The pledge is a common law security that, unlike continental European securities of the same name,[50] requires possession to be held by the creditor, subject to cases where a temporary or limited release is allowed.[51] This rules out pledge for intangible property,[52] except for negotiable instruments. Pledge also is either unavailable or not employed in the case of land. Pledges by 'consumers' to 'pawn-brokers' are a very old institution that has had something of a revival in recent years as more consumers have come to own valuable goods. In the commercial context pledge is used frequently in the case of short-term advances against shipping documents in the export trade, but for business security generally it is of less practical utility. A pledge cannot sensibly be used in the case of revenue-generating assets that the debtor must put to work to create an income stream to service the debt.

1.18 **Mortgages and charges** Non-possessory security devices consist of mortgages and charges. For personal property, a mortgage is a defeasible outright transfer of the property subject to the mortgage that is automatically reconveyed to the debtor upon repayment of the mortgage advance.[53] A charge, however, is an encumbrance over property that is lifted when the advance is repaid. There is no transfer of the property to the creditor.[54] A mortgage may be legal or equitable, which is a distinction of no consequence for insolvency purposes, which is where the taking of security really matters. A charge, on the other hand, is necessarily equitable since the common law requires a strict measure of identification of particular assets to a security that is not required in equity. In principle, a wider range of remedies is available to a mortgagee creditor than to a chargee creditor, but the ability of chargee creditors to draft a fuller range of remedies for a charge than is otherwise provided for eliminates the distinction in practice.[55] In such cases, it would usually make no practical difference between identifying the enhanced security as an extended charge and identifying it as a mortgage, though called a charge.[56]

1.19 **Non-consensual security interests** There are also a number of security interests that arise by the operation of law.[57] Many of them date back several centuries, and it is hard to find a coherent rationale for when they arise. Certainly, the common law displays no inclination to add to the list of these interests. For this reason, lenders will normally prefer to put in place

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[49] *Re Cosslett (Contractors) Ltd* [1998] Ch 495 (Millett LJ). A lien arising by operation of law can be expanded by contract so that the group of three security devices might be seen as four. For the purposes of the present discussion there is little practical difference between the pledge and the contractual lien and what is said about pledges applies equally to the lien. For further discussion see para 4.04.

[50] And so-called 'pledges' of financial collateral, which are in law mortgages or charges: see para 3.21.

[51] *Re David Allester Ltd* [1922] 2 Ch 211. See para 5.28.

[52] *Harrold v Plenty* [1901] 2 Ch 314.

[53] *Keith v Burrows* (1876) 1 CPD 722.

[54] *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd* [1985] Ch 207.

[55] See para 18.19 et seq.

[56] Ibid. See also para 6.54 et seq.

[57] Considered at paras 5.56 et seq and 6.140 et seq.

their protection at the time of lending,[58] and the non-consensual devices are only relied upon as a safety net if the other protection is inadequate.

E. Quasi-security: reservation of title

General nature of quasi-security devices We said earlier that there are a number of transactions involving the retention of title that are not classified by the current law[59] as security but that serve the same economic function. The principal forms are the finance lease,[60] the hire purchase contract[61] and various types of conditional sale agreement. The latter may be subdivided into those under which a fairly large item is supplied and the buyer is to pay the price in instalments, and agreements under which goods are supplied for re-sale or as materials or parts for manufacture into other goods under a 'retention' or 'reservation' of title clause. Other transactions include sale and leaseback and sale and buyback, where care must be taken in drafting the agreements to avoid the risk of their being recharacterized as charges.[62] **1.20**

Conditional sales

'Simple' retention of title not charges In the last thirty years, trade creditors supplying goods to the debtor have increasingly availed themselves of rights under the Sale of Goods Act 1979 to reserve title to the goods supplied, which otherwise would become the buyer's property, usually upon delivery. The courts have been insistent that such reservation of title clauses are not charges so far as they remain confined to the particular goods supplied.[63] This conclusion is of no small advantage to these trade creditors in that they thereby enjoy a dual advantage over banks and other financiers. First, they do not have to register their reservation of title clauses in order to assert them against third parties. Secondly, so far as the buyer has not acquired rights to the goods supplied, even a pre-existing mortgage or charge granted to another creditor will not attach to the goods, which ensures that the trade creditor will have priority over such earlier creditors in respect of the goods supplied. Furthermore, trade creditors will by virtue of this same principle be able to assert their proprietary rights in the event of the buyer's insolvency. **1.21**

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'Extended' reservation of title clauses are usually charges Nevertheless, reservation (or retention) of title clauses have their limitations. They have little practical utility if the goods have a limited commercial life. When sellers have sought to extend the ordinary reach of such clauses to take in new goods manufactured with the aid of the seller's goods, the courts have interpreted attempts to 'reserve' title to these goods newly manufactured by the buyer with the help of the seller's goods as charges. The courts have moreover declined to give effect to attempts in other extended reservation of title clauses to treat the buyer as a trustee or **1.22**

[58] This may include modifying a non-consensual device, so that a possessory lien may be extended by contract.
[59] For proposals to treat the two in the same fashion, see para 23.74.
[60] See further para 7.43.
[61] See further para 7.34
[62] E.g. *Re Curtain Dream* [1990] BCLC 925.
[63] See paras 7.10–7.11.

fiduciary of the money proceeds of the resale of goods supplied by the seller as anything other than a charge.[64]

1.23 **Other conditional sales** Sales under which the buyer is to pay the price in instalments and the seller reserves title until the price has been paid perform the same function as hire purchase or finance leases. The latter forms of transaction were developed to avoid the risk that the buyer in possession of the goods might sell them free of the original seller's interest, and for other reasons not directly connected to security.[65]

Finance leases and hire purchase

1.24 **Finance leases and hire purchase agreements** It is unchallengeable orthodoxy that financial leasing and hire purchase agreements should be treated as what they purport to be, namely as transactions reserving title in the financier whilst granting use to the debtor, either indefinitely or until an instalment payment plan has been carried out in full.[66]

Discounting

1.25 **Sales of receivables** In a similar vein, the courts have treated the sale or discounting of book debts (or receivables) as genuine sale arrangements, notwithstanding the close functional similarity these arrangements bear to equitable charges over book debts as security for advances.[67] There is little to differentiate a money advance by way of loan and the purchase price of a debt or debts. The judicial treatment of both types of transaction as not amounting to charges is well established and not likely to be reassessed in the light of the judicial treatment of extended reservation of title clauses.[68]

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F. Form and substance and recharacterization risk

1.26 **Meaning of the substance test** Apart from a close scrutiny of extended reservation of title clauses and a recharacterization of them as charges, the English courts have shied away from applying functional, economic analysis to contractual devices that are framed as being other than mortgages and charges. They apply instead a so-called substance test, by which such a device will be treated as a security if that in substance is what it is. This approach, nevertheless, falls short of functional analysis and amounts to no more than requiring the parties to follow accurately the steps laid down in their transaction. That is to say, if the parties say one thing and do another, the transaction will be characterized according to how they act and not according to what they say.[69] Although in principle contracts are not to be interpreted in the light of the parties' subsequent conduct,[70] the characterization of an agreement as giving rise to a charge or otherwise does seem to depend in part on subsequent actions. This liberal approach permits contracting parties to keep transactions off a company's balance sheet and

[64] See para 7.12 et seq.
[65] See paras 7.36 and 7.46.
[66] See ch 7.
[67] *Olds Discount v John Playfair* [1938] 3 All ER 275; *Lloyds and Scottish Finance Ltd v Cyril Lord Carpet Sales* (1979) [1992] BCLC 609.
[68] See para 7.102 et seq.
[69] *Re George Inglefield Ltd* [1933] Ch 1; *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148.
[70] *Whitworth Street Estates (Manchester) Ltd v James Miller and Partners Ltd* [1970] AC 583; *LG Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235.

to avoid the registration of charges requirement laid down in the Companies Act. It is nevertheless important to recognize that contracting parties are not free to label a transaction as the one they might wish it to be. They may be free to lay down its incidents—the rights and duties to which it gives rise—but ultimately it is for the court to characterize the transaction according to type in the light of those rights and duties.[71]

1.27 **Sham transactions** A more extreme case where a transaction is recharacterized is that of the 'sham', whereby all the parties to a transaction possess the intention that the transaction not give rise to the rights and duties that it appears to create.[72] Transactions of this kind are deceptive and pose the risk of fraud for interested third parties. We shall see, however, that it is rare in modern times for the courts to recharacterize transactions in this manner.[73]

1.28 **Fixed and floating charges** A less extreme recharacterization is disclosed by the willingness of the courts, particularly in recent years, to decide what type a security is, and in particular whether a charge is a fixed charge or a floating charge, by looking at its substance and ignoring the label the parties may have chosen in their agreement. Thus English courts will characterize as a floating charge a security over book debts that is expressed to be a fixed charge but that imposes insufficient controls over dealings with those book debts and their proceeds to pass the test of a fixed charge.[74]

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G. Statutory interventions on behalf of unsecured creditors

Preferential and similar rights

1.29 **Subordinating floating charges** Although the English courts have done nothing for the plight of unsecured creditors, apart from occasionally expressing sympathy for their plight,[75] Parliament has responded more effectively on their behalf. First of all, it introduced a category of preferential creditors who, apart from their classification as such, would have ranked simply as general unsecured creditors. Parliament advanced these preferential creditors, not just ahead of other unsecured creditors, but also ahead of secured creditors holding a floating charge.[76] A wedge was thereby driven between different classes of secured creditors, and the holders of a floating charge were expropriated in favour of the new class of preferential creditors. In later years, the classes of preferential creditors were reduced in number, whilst Parliament also reined in attempts by the holders of floating charges to draft their way around the rights of preferential creditors with the aid of so-called automatic and semi-automatic crystallization clauses.[77] Secondly, in the Enterprise Act 2002, Parliament introduced a fund drawn from floating charge assets but limited in amount and dedicated to all unsecured creditors.[78]

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[71] See, e.g., Lord Millett in *Agnew v Commissioner of Inland Revenue* [2001] UKPC 28, [2001] AC 710 at [32]. See paras 4.13 et seq and 6.99 et seq.

[72] *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786, 802 (Diplock LJ).

[73] See para 4.15 et seq.

[74] *National Westminster Bank plc v Spectrum Plus Ltd* [2005] 2 AC 680, HL. See para 6.96 et seq.

[75] *Salomon v A Salomon & Co Ltd* [1897] AC 22, HL (Lord Macnaghten); *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 1 WLR 578 (Templeman J).

[76] See now Insolvency Act 1986 as amended, s 386 and Sch 6.

[77] See para 20.23.

[78] See Insolvency Act 1986, s 176A as amended by the Enterprise Act 2002. See para 20.25 et seq.

Registration

1.30 **Publicizing charges** In other respects, Parliament left secured creditors and debtors to their own devices, with this exception. English law has not for centuries adhered strictly to the notion that unpublicized transfers or encumbrances are the badge of fraud and are to be struck down on that account.[79] Nevertheless, for more than a hundred years, non-possessory security in the form of mortgages and charges has had to be registered if it is to be effective against other secured creditors and the insolvency representatives of the debtor representing the unsecured creditors of the debtor.[80] English law has always required registration of the charge or mortgage itself, rather than the filing of a notice that such a security has been taken. The registration requirement by no means provides all the information that creditors and potential creditors of the debtor would wish to have.[81] Conditional sales, financial leasing, and hire purchase agreements, serving the same economic purpose as security, have never had to be registered.

1.31 **Limitations of the registration system** So far as reservation of title creditors might wish to avail themselves of the registration machinery to take advantage of extended reservation of title clauses, their attempts to do so would be blocked by inherent limitations in the English law of security. Trade creditors supply goods to debtors at intervals and usually not in response to a pre-existing commitment taking the form of a requirements contract. The difficulty to which this gives rise is that English law does not permit the trade creditor to register a charge or mortgage for all present and future supplies. A creditor is allowed to 'tack' a fresh advance to an earlier security only in very limited circumstances.[82] When a trade creditor, having registered a charge over present and future assets, then makes a subsequent delivery, the rule against tacking will subordinate that creditor, to the extent of the new advance, to the rights of secured creditors who have registered their charges in the interval between the trade creditor's initial registration and the later advance. Furthermore, to repeat registrations for relatively small supplies is not an economical proposition.

H. Creditors' preferences

1.32 **Different types of creditor** The broad range of security and devices akin to security covers a range of different types of creditor and their needs. The pledge, a strong security giving the creditor a firm measure of control, has been seen to be inapt where the assets have to be put to productive use by debtors. Banks do not participate in business activity with their customers, nor do they adopt a passive partnership role, so the hallmark of a working security arrangement is one that leaves the debtor free to deal with its encumbered assets in the ordinary course of business. This is especially true of those assets that constitute a debtor's working capital, such as its book debts. Pledges are therefore useful only for short-term advances in the export trade, as well as for non-productive assets, such as precious and other metals, where documents representing those assets, such as warehouse receipts, can be taken

[79] *Twyne's Case* (1601) 3 Co Rep 80b, 76 ER 809.

[80] See Companies Act 2006, ss 860 and 874, replacing Companies Act 1985, ss 395–396; Bills of Sale Acts 1878–91. Not all mortgages and charges need to be registered: see para 10.16.

[81] For the registrable particulars, see para 10.11.

[82] See para 14.78 et seq.

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into possession. In international loans, a preference has been seen for unsecured lending backed by detailed financial covenants.

1.33 **Banks and their subsidiaries** In their dealings with borrowers, banks have used a range of fixed and floating charges, the latter type of charge sweeping up everything that cannot be accounted for by means of a fixed charge. Finance houses, often owned by major banks, are heavily engaged with equipment financing, by means of hire purchase and financial leasing arrangements. They are also highly active in the factoring of book debts, a practice that is likely to become more pronounced now that the prospects of taking a fixed charge over book debts are so severely reduced. Factors purchasing book debts are not vulnerable to the claims of preference creditors and unsecured creditors availing themselves of new rights granted by the Enterprise Act 2002 in the way that a bank taking a floating charge over book debts is.

1.34 **Securitization** In securitization arrangements, where assets are sold to a special purpose vehicle (SPV) that then issues commercial paper to a community of investors, the seller of those assets is protected mainly by keeping the SPV bankruptcy remote and by the dispersal of risk inherent in the size of that community. The taking of security over receipts in the hands of the SPV amounts therefore to an ancillary source of assurance, likewise the various forms of credit enhancement used in securitization.

1.35 **Trade suppliers** The English law of security, with its registration and other requirements, leaves trade suppliers in a difficult position. Quasi-security in the form of reservation of title has been adopted mainly in the case of raw materials and other items with a short commercial life, such as stock-in-trade. Substantial capital assets can be sold to a finance house, which will then make them available to their subsequent users on hire purchase and similar terms. The original supplier, meanwhile, has its cash-flow needs met out of the sale price it receives from the finance house.

1.36 **Conclusion** The diversity of the English law of security and its cognates reflects a diversity of need in the market place and the willingness of the law to allow parties to engage in forms of off-balance-sheet financing.

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