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NULLIFICATION OF BAN ON INVOICE ASSIGNMENT CLAUSES

1 This is a response by the Financial Law Committee of the City of London Law Society to the Consultation Paper issued by the Department for Business Innovation and Skills in December 2014. It is concerned with the proposal to nullify bans on invoice assignment clauses by regulations to be made under the Small Business, Enterprise and Employment Bill.

2 The City of London Law Society (CLLS) 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. They act for every type of party to a financing transaction, including lenders, borrowers and counterparties to assigned contracts.

Summary

3 We believe that the proposed legislation approaches the issue in the wrong way, and that there are preferable ways to deal with it. If the legislation is to proceed, more thought needs to be given to the extent of its application.

4 In commercial transactions (as opposed to consumer ones), the parties should generally be free to decide for themselves what their contract says. Parties from all over the world use English law for their contracts because it gives effect to that fundamental principle.

5 Freedom of contract should only be restricted in commercial transactions in exceptional

circumstances – where there is clear evidence that allowing the parties to decide for themselves materially damages the UK economy. We have not seen such evidence in relation to restrictions on assignment.

6 We are aware that restrictions on assignment do cause practical problems in financing transactions. Indeed, it is one of the issues which we are looking at in our review of secured transactions law. But we do not consider that the problem is so grave that it warrants overriding the rights of one party to a contract in order to give an advantage to the other party.

7 We consider that the best way to deal with the problem is consensually – by explaining the issues to parties and encouraging them to agree restrictions on transfer which allow receivables to be sold or charged by the payee whilst at the same time protecting the legitimate interests of the payer. The right approach is very much dependent on the particular contract concerned. The issues are too nuanced to be solved by legislation which simply prohibits certain contractual provisions.

8 If it is decided to proceed with the proposal to override the agreed terms of business contracts, the payer should not suffer as a result. The legislation should make it clear that the payer's economic obligations will not be increased as a result of the payee assigning the receivable to a third party in breach of the terms of the contract.

9 If the legislation is to proceed, the scope of its application also needs to be clarified in order to avoid legal uncertainty and damage to the use of English law in international transactions. In particular:

- Since the purpose of the legislation is to protect small businesses, why is it not restricted to payees which are small businesses? Is it really intended to benefit large multinational companies?

- Why is there no territorial limitation on the application of the legislation? Is it intended to apply to all contracts governed by English law, regardless of where the parties are situated? Or to contracts between parties situated in the UK, regardless of the law which governs them? Or by some combination? These are important issues which need to be addressed and resolved.

10 We also believe that the economic impact assessment prepared has given no weight to the adverse economic effects of the proposals, both directly on payers and indirectly as a result of potential damage to the use of English law in contracts under which

receivables are created, or to litigation and arbitration of such contracts before English Courts and arbitral bodies in England.

11 If there is any particular group of powerful counterparties which is established on the basis of clear evidence (such as the outcome of a CMA Market Investigation, evidence to relevant Parliamentary Committees or Regulators) to be causing particular problems to small businesses by use of these clauses, the specific regulatory action (most regulators have power to make binding orders) to prohibit use of these clauses by members of such a group on a targeted basis would be appropriate and would clearly be proportionate to the issue.

Background

12 The Financial Law Committee of the CLLS has, for many years, been involved in the various proposals for reform of the law of secured transactions. In November 2012, it produced a Discussion Paper on Secured Transactions Reform. The purpose of the Discussion Paper was to identify those areas of the law which it considered to be in need of reform.

13 One of the areas which it identified was restrictions on transfer of receivables. It was not considered to be the most pressing of issues, but it was thought worthy of further consideration. A working party of the Financial Law Committee is currently considering the issue.

14 The availability of finance is crucial for all businesses - both small and large; and restrictions on the transfer of receivables do create problems in practice. It tends not to be an issue where security is taken over major contracts, because it is clear that they often need to be financed and they are drafted accordingly. But it is a problem in cases where security is taken over smaller, pre-existing, contracts. An assignment or security interest taken over the benefit of a contract which contains a relevant restriction is ineffective.

15 This can be a problem for financiers but, equally, restrictions on assignment can be inserted for good commercial reasons. Even when what is being assigned is the benefit of a receivable, there may be good reasons why the payer wants to control the identity of its payee. And it will certainly want to ensure that its liability to the assignee is no greater than its liability to the assignor. The general law on assignment gives some protection to the payer in this respect, but it is not complete protection.

16 The problem is to find a balance between the need to create security over receivables and the need to protect the payer. In our view, this is best done by encouraging the parties to the contract to agree any limits of assignability themselves, not by overriding the parties' agreement in a wide range of contracts and imposing a solution which benefits one party at the expense of the other.

Question 1

Policy Issues

17 Our main comment on the draft regulations is that they approach the problem in the wrong way. A balancing needs to be made of the interests of both parties to the contract, and that is best done by the parties themselves. In our view, it is simply not appropriate to override the parties' agreement and impose a solution which benefits one party (or its financiers) at the expense of the other party.

18 This concern is borne out by the exceptions which are made to the regulations – particularly in relation to financial services. It is recognised, quite rightly, that it could create major problems in the financial services sector if the law was simply to override the agreement of the parties. What is true of the financial services sector is true of other areas of business. Counterparties to contracts may have good reasons why they want to deal with their contracting party, and not with anyone else. And that is as true of their obligation to pay money under the contract as it is of any other provision of the contract.

19 The extent of the application of the regulations is also puzzling:

(a) They are expressed to apply to assignments of receivables. Presumably, this is intended to apply to security assignments as well as to outright assignments. But what about charges over receivables?

(b) The purpose of the legislation appears to be to benefit small businesses. But the regulations outlaw restrictions on assignment in any relevant contract, even if it is made between two large multi-national companies.

(c) Even if it were restricted to small companies, it should not be forgotten that for every small company which is owed a receivable, there is another small company which owes one. Is it appropriate to override the interests of a small company payer in favour of a small or large company payee? Particularly where, as drafted, the legislation would expose the small company payer to additional

financial risk. In other contexts, small businesses would often be afforded the same protection as consumers, who as payers do benefit from the exclusion created by Clause 2(2)(c) of the draft SI.

Territorial and Conflict of Law Considerations

20 There is no territorial limit to the regulations. Parties across the world choose English law to govern their contracts because the courts will give effect to the terms of the contract in practically all circumstances. That is one of the great attractions of English law for the international business community and an important economic resource of the United Kingdom. The effect of the regulations would be to cut across this principle and to prohibit restrictions on assignment in international contracts where there is no small UK business to protect. Is that what is intended?

21 It is particularly unfortunate that the conflict of laws aspects of this proposal are not dealt with adequately in the consultation paper. We note that it is the intention that the regulations will not apply to contracts governed by Scots law, but this is not clearly the effect of enacting a provision relating to all contracts under legislation that applies only outside Scotland. It is quite likely that the English courts would, for example, view the rule as it appears in the draft SI as one applying to contracts governed by any law but being enforced in England. As the Rome 1 Regulation is applicable as between England and Scotland,[1] this would mean that a Scots law prohibition being enforced in the English courts would be affected by the law. The same considerations apply as between Scotland and Northern Ireland if this law will apply in Northern Ireland.

22 By implication from the consultation paper, it might be assumed that the SI would not apply to foreign law contracts at all. As drafted, however, the provision may catch not only Scots law contracts enforced in England and Wales against English and Welsh businesses, for example, but also those governed by third country laws and so enforced.

23 It is also unclear what "long-arm" effect is intended. For example, is it intended that the measure applies to all English law contracts described in the SI wherever in the world they have effect or are created? Is it intended that the law should also apply to foreign law contracts (including Scots law contracts) which take effect in England and Wales

1. Law Applicable to Contractual Obligations (England and Wales and Northern Ireland) Regulations 2009 (SI 2009/3064), Reg.5,

(and Northern Ireland) wherever in the world they are enforced? As the SI is drafted these issues could give rise to protracted litigation and consequent damage to the reputation of English law.

24 We think it is essential, in order to reduce legal uncertainty, that, if this measure is to be taken, the Government consider which options it intends to take on the territorial and legal scope of the measure[2] and revises the draft SI to clarify the options chosen:

(a) If it is intended to apply the measure only to contracts governed by the law of England and Wales (and Northern Ireland) this should be stated in the SI. There is an additional possibility to limit the application of the law substantially to contracts which take effect in the UK, as, for example, in Section 27 of the Unfair Contract Terms Act 1977 ("UCTA"), which disapplies UCTA to contracts which are governed by English law "only by the choice of the parties". This would limit, but not entirely[3] remove damage to the use of English law.

(b) If it is intended to create a public policy measure which will be applied when Courts in England, Wales and Northern Ireland are asked to enforce such a clause regardless of governing law, it would be helpful to supplement the existing drafting with a clear statement that this is a public policy rule to be applied by these courts for the purposes of Article 21 of the Rome 1 Regulation. This would seem better designed to prevent evasion by the use of foreign laws in relation to, for example, contracts performed by English parties in England, but would still probably apply to English law contracts enforced outside the UK and to "choice only" English law contracts enforced in the UK, unless there were another exclusion making it clear it was not to be applied to contracts where neither the payer nor the payee had a place of business in the UK.

(c) If it is intended to create a mandatory rule for the purpose of Article 9 of the Rome 1 Regulation (which would apply not only when, for example, English law were the chosen law or a dispute was being determined by the English Courts, but potentially throughout the EU and in some other jurisdictions to contracts to be performed in England, regardless of governing law), then the language of the SI at Article 3 would seem to need to go beyond "no effect" and make these

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2. Dicey and Morris on the Conflicts of Law, Chapter 32 Sections 3 and 8 deal with the issues discussed.

3. Contracts which create a receivable can be governed by English law under Rome 1 rules, excluding choice of law, in some circumstances where neither the payer or the payee are present in the UK.

clauses or their enforcement unlawful (it is clear that a mandatory law has to make something illegal although precisely how far that has to go in relation to a contractual term of negative effect is uncertain). If the contract term itself were to be made illegal, then it should be considered whether it is desirable to state that this is not to affect the validity of the contract as a whole: this in itself is not an entirely simple question.

Economic Position of the Parties

25 If it is decided to proceed with the regulations, in our view it is very important to ensure that the respective economic positions of the payer and the payee under the contract are not altered. They should not prejudice one of the parties to the contract (the payer) for the benefit of the other (the payee).

26 It therefore needs to be made clear in the regulations, if they are to be given effect, that the assignment will not prejudice the payer. For instance, the payer should be able to exercise the same rights of set-off which it would have had in the absence of the assignment. This would not be the case under the general law. Once notice of assignment is given, the payer is unable to exercise new rights of set-off which it obtains against the assignor. In our view, the payer should be able to exercise these rights against the assignee, even though there has been an assignment. If the contract prevents assignment, it would be unfair on the payer to require it to pay more than it would have had to pay if the terms of the contract had been complied with. The payer may only enter into the contract if it has certainty that set-off rights will be available to it in the future. If this premise is altered then it may dissuade payers from entering into legitimate commercial contracts.

27 This consideration is particularly important in a law which has been drawn far more widely than its intended purpose would suggest: for example a small business payer may depend upon a "running account" with a business counterparty for its solvency, but this rule could expose it to claims from the counterparty's financiers (assignees) which it did not expect and leave it chasing the counterparty for payment of amounts due to it. Such unexpected financial mismatches could even cause the failure of a business.

28 If the regulations are to be adopted, we therefore suggest an additional regulation on the following lines:

"If, as a result of the operation of paragraph 3(1), a receivable is assigned which

would not otherwise have been assignable, the receivable debtor cannot be required to pay a greater amount to the assignee than would have been payable to the assignor under the contract in the absence of an assignment, nor to pay on different terms (other than as to the identity of the payee)."

29 There is a further concern for payers. They may have inserted restrictions on transfer in order to avoid breaching money laundering or sanctions laws or regulations. Overriding the restrictions could result in the payer being liable for civil or criminal penalties.

Question 2

30 No. We do not consider that the nullification of bans on invoice assignment is the best way to deal with the problem. Our reasons are set out above. In addition, if there are problems with particular classes of suppliers with market power preventing receivables assignments, then that is best dealt with through competition law or sectoral regulation with a clear UK scope, rather than by provisions which affect freedom of contract generally.

Question 3

31 It seems to us to be counter-intuitive to override contractual provisions in agreements between businesses, but not where consumers are involved. It is commonplace to override contractual provisions in consumer contracts in order to protect the consumer. There should be no need to override contractual provisions in business contracts. The parties may, or may not, have equivalent bargaining power, but issues of that kind are best dealt with by competition and regulatory law, not by overriding parties' agreements.

Question 4

32 If the regulations are to come into effect, we agree that financial services contracts should be excluded.

Question 5

33 The problem with definitions of this kind is that they draw an arbitrary line between those types of contract where the regulations apply, and those where they do not. That can give rise to difficult issues of interpretation, and therefore uncertainty; and it can also lead to arbitrage, including, if the intended approach is that indicated in the

consultation, to the use of contracts governed by foreign laws to deal with entirely English matters, as well as overseas ones. This would damage the use of English law in international trade and business to no good purpose and have adverse economic effects on the UK economy.

Question 6

34 What is true of financial services contracts is doubtless true of many other business contracts where the parties should be free to agree the terms on which they contract. It is impossible to list them all. This simply shows up the danger of legislating in this way.

Question 7

35 If the legislation is to be passed, we agree that tenancy agreements should be excluded.

Question 8

36 Clauses of this kind are simply an illustration of the types of case where, for good commercial reasons, restrictions are imposed on assignment. It is invidious to exclude this type of case from the regulations whilst, at the same time, allowing the regulations to apply in cases where there are equally good commercial reasons to limit assignments.

Question 9

37 We agree that commercial confidentiality is an important contractual freedom for debtors. But this is no different in kind or degree from any other contractual provision which the parties have inserted in the contract. The whole point of writing down the terms of a contract is so that they will or should be given effect to.

Question 10

38 A contract can contain a restriction on assignment either because it is written into the contract itself or because it is imported by reference to another document. In either case, the restriction on assignment is a term of the contract, and therefore there is no reason to refer to linked contracts.

Question 11

39 If the regulations are passed, we agree that there is an argument that there should not

be a limit on those who can benefit from it. In particular there may be an EU requirement to ensure that EEA businesses can benefit from it. However, when it comes to disbenefit, there is no requirement to make that universal and the general rules of comity would opposed to such an approach. We refer you to our comments in response to Question 1 on the need to limit the damage this legislation can do.

Question 12

40 If the regulations are passed, it is, in our view, extremely important to protect the payer from the fact that the agreed terms of the contract have been overridden. These issues are discussed in our answer to question 1.

Question 13

41 In our view, the most appropriate people to deal with contractual disputes are the parties to the contract. That is one of the reasons why prohibitions on assignment are included in many contracts. It makes little sense to require the assignee to deal with an issue about which it will largely be ignorant.

Question 14

42 We consider that it is important that the payer should have all rights of set-off which it would otherwise have had in the absence of an assignment. Because this is not the position under the general law, it needs to be expressed in the regulations. We discuss this in our answer to question 1.

Question 15

43 In our view, further time should be taken to consider whether it is really sensible to override contractual provisions in the way proposed in the draft regulations.

Question 18

44 We do not consider that this measure will reduce the overall cost of finance for small businesses. When legislation is passed which overrides commercial parties' freedom to contract on their own terms, they normally manage to come up with ways in which they can get round the problem. In our experience, this simply increases the costs of transactions. In addition, small business payers who have relied on "running account" arrangements with counterparties, could lose rights of set-off and be exposed to unexpected claims from their counterparty's financier (or other assignee).

Question 19

45 No. We do not agree that the costs of these regulations will be very low. We think that the measure will increase costs for users of English law in commercial contracts and damage the economic interests of the UK in relation to the international use of English law and choice of English courts for resolution of international disputes. See our comments above. Our comments in answer to Question 1 illustrate the high degree of legal uncertainty created by the terms of the draft SI.

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