

**SECURED
TRANSACTIONS CODE
AND
COMMENTARY**

**Discussion Draft
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GLOSSARY
of some expressions used in the Code

Expression	Section
asset registry	37.8
charge	2.1
charged asset	11.1
chargee	19.1
chargor	19.1
current asset	41.2
equitable charge	3.2
equity of redemption	4.1
exempt charge	27.2
financial collateral charge	29.1
fixed asset	41.3
future asset	12.1
goods	11.8(b)
insolvency claw-back proceedings	51.3(d)
insolvency legislation	51.3(a)
insolvency officer	51.3(c)
insolvency proceedings	51.3(b)
intangible	11.8(c)
intention	5
land	11.8(a)
legal charge	3.1
possessory charge	28
receivables financing agreement	35.1
registrable charge	27.1
registrar	26.4
secured obligation	18.1
UK business	26.3

INTRODUCTION

- 1 The purpose of the Code is to create a new law of secured transactions, based on the existing law but simplifying and modernising it.
- 2 The purpose of this Commentary is to give some context to the Code.
- 3 The reason we start with the existing law is that, as a general rule, it works well in practice. In particular, the principles upon which the current law is based are well suited to commercial practice, and what we have attempted to do in the Code is to state them as clearly and simply as we can.
- 4 But, because the law has developed over 400 years, the underlying principles have become encrusted with detailed rules which are often much more complicated than they need to be and which often do not reflect current practices. What we have attempted to do here is to remove the barnacles and to create a system which is simpler and clearer than the current law and which reflects more closely what parties actually need in practice.
- 5 A word about the drafting. Our intention, when drafting the Code, was to make it as understandable as possible to anyone who wants to know how secured transactions work. We have therefore quite deliberately not drafted it in the form of a normal statute. The Code is not doing what most statutes do. Most statutes change the law, and their purpose is therefore to state what those changes are. The Code has a different purpose. It is intended to codify the law, as well as to change it, and we have looked as guides to the great nineteenth century codifications as examples of attempts to systematise the law in as clear and straightforward a way as possible.
- 6 In the result, there is some repetition in the Code. This is quite deliberate. The intention is to make it as readable as possible not just to lawyers but also to others who want to understand how the law of secured transactions works.
- 7 One of the most important aspects of the current law is its flexibility. It enables the law to adapt to changing commercial practices. The intention behind the way the Code is drafted is to preserve that flexibility. As far as possible, the Code is drafted at a level of principle which should enable it to give effect to changing ways of doing business.
- 8 The purpose of this Commentary is to put the Code in context. By doing this, we hope to make it more readily understandable to those who read it. The Commentary puts

the new law in the context of the existing law, explains why the Code says what it does and gives examples of how the law should be applied in practice.

- 9 Our intention is that the Code is brought into law by enabling legislation. The legislation could give the Commentary official standing as a guide to interpretation of the Code. The implementing legislation would also deal with important issues such as transitional rules, which are not dealt with in the Code itself; and it could contain a power to amend the Code by secondary legislation.

PART 1: WHAT IS A CHARGE?

- 1 The power to create a charge**
- 1.1 A chargor can create a charge over a charged asset in favour of a chargee to secure the performance of a secured obligation.**
- 1.2 These expressions are described in more detail later. In brief:**
 - (a) the chargor can, subject to the limitations described in part 5, be any person;**
 - (b) the chargee can be the creditor to whom the secured obligation is owed or it may be another person (such as a trustee) for the benefit of that creditor;**
 - (c) the charged asset can be any present or future interest in property of any kind if the interest is capable of being transferred or if a proprietary interest can be created over it; and**
 - (d) the secured obligation can be any obligation or liability of any kind, and it does not have to be owed by the chargor.**
- 1.3 This Code is concerned with charges created by a chargor. It is not concerned with charges which arise by operation of law.**
- 1.4 Any number of charges can exist concurrently over the same charged asset.**
- 1.5 It is not necessary for the chargee to obtain possession of the charged asset but, if possession is obtained, the chargee may obtain the benefit of having a possessory charge or a financial collateral charge (see part 7).**
- 1.6 A charge can be created over a charged asset even if the chargor has the authority to dispose of the asset concerned free from the charge or to deal with it in any other way without the consent of the chargee. The powers of the chargor (and the chargee) in respect of the charged asset are a matter to be decided between the parties (see part 6).**

Commentary

- 1 Section 1 contains the power to create a charge.**

- 2 **Section 1.1** describes the basic principle, and **section 1.2** elaborates on that. Everything in **section 1.2** is repeated elsewhere in the Code in the appropriate place. The purpose of this section is to set the scene for the reader.
- 3 Most charges are created consensually as part of a secured transaction. The Code is concerned with charges of this kind. See the first sentence of **section 1.3**.
- 4 Security can also arise by operation of law. Security of this kind is normally referred to as a lien. Liens are excluded from the Code. See the second sentence of **section 1.3**.¹
- 5 The reason for excluding liens is essentially a practical one. It is possible to codify and simplify the law of consensual security interests without dealing with liens. It would, nevertheless, be possible to add liens if that were thought desirable.
- 6 The law concerning legal liens is relatively clear and straightforward, although it would doubtless benefit from a simple restatement.
- 7 Equitable liens are much more intractable. The factor which unifies legal liens is the requirement for the creditor to obtain possession of the asset concerned. That is not a requirement of equitable liens, and it is difficult to find a corresponding defining characteristic for them. Indeed, Gibbs CJ in the High Court of Australia in *Hewett v Court*² said: “It would be difficult, if not impossible, to state a general principle which would cover the diversity of cases in which an equitable lien has been held to be created”.
- 8 This is a problem, but also an opportunity. There would be merit in exploring the possibility of establishing a clear set of rules for equitable liens. But the difficulty in finding a consensus should not be underestimated.
- 9 We would welcome comments on whether or not the Code should cover liens.
- 10 **Sections 1.4 to 1.6** demonstrate the breadth of a chargor’s power to create a charge.
- 11 As under the current law, there is no limit to the number of charges which can exist concurrently over the same charged asset (**section 1.4**). It might have been thought that, because a chargor has charged an asset in favour of A, all that it can charge in favour of B is its equity of redemption, and therefore that B necessarily ranks behind A.

¹ Contractual liens are created consensually. They do fall within the scope of the Code. See **section 10.2**.

²(1983) 149 CLR 639 at 645

But that is not always true under the current law. The question is one of priorities, which is dealt with in part 8 of the Code.

- 12 Under the existing law, most types of security can be created without the secured creditor taking possession of the assets concerned. The exception to this is the pledge, which is only effective whilst the creditor has possession of the pledged goods. Under the Code, the equivalent of a pledge is a possessory charge. The main practical distinction between pledges and other types of security is that pledges do not require to be registered at Companies House. This distinction is recognised in the registration provisions of the Code (see part 7). Possession of financial collateral may also result in the charge being a financial collateral charge (see part 7), although, in this context, “possession” is used in a different sense. See **section 1.5**.
- 13 **Section 1.6** reflects one of the most important principles of English security law – that it is possible to create security over an asset even if the chargor is given the authority to deal with it free from the charge. This principle was established in the 1860s³ in England although it took much longer in the United States⁴.
- 14 Charges of this kind soon became known as floating charges⁵. The Code recognises the ability to create a charge of a kind which would be described as a floating charge under the existing law, but the Code does not distinguish between “fixed” and “floating” charges.
- 15 The distinction is important under the current law for two reasons. In the first place, the priority rules are different depending on whether the charge is fixed or floating. And, secondly, recoveries under a floating charge are subject to certain imposts in an insolvency to which fixed charges are not subject.
- 16 The Code deals with priorities in a different way. Rather than distinguishing between the nature of the charge, the Code looks to the nature of the asset concerned (see part 8 of the Code). The position on insolvency is contained in part 10 of the Code.

³*Re Marine Mansions Company* (1867) LR 4 Eq 601; *Re Panama, New Zealand and Australian Royal Mail Company* (1869-70) LR5 Ch App 318.

⁴*Benedict v Ratner* 268 US 353.

⁵*Re Colonial Trusts Corporation, ex parte Bradshaw* (1879) LR 15 ChD 465 at 472.

2 The nature of a charge

- 2.1 A charge is a proprietary interest in a charged asset which secures the performance of a secured obligation.
- 2.2 Because it is a proprietary interest, a charge created by a chargor over an asset is not only enforceable against the chargor. Subject to the insolvency legislation, it is enforceable against an insolvency officer of the chargor (see part 10). It can also be enforced against other persons who obtain an interest in the asset, the extent to which it can do so depending on part 8 of this Code and the rules of property law at common law and in equity.

Commentary

- 1 **Section 2.1** explains what a charge is.
- 2 **Section 2.2** explains why it is so important that a charge is a proprietary interest.
- 3 The whole point about taking a charge is that it will, as a general rule, be effective in the chargor's insolvency. Whilst its debtor is solvent, a creditor can rely on the debtor's personal obligation to pay, or to repay, the debt. But, if the debtor is insolvent, a personal claim will rank *pari passu* with all other personal claims, and the creditor will only receive a dividend on its debt.
- 4 Because a charge creates a proprietary interest in the charged asset, the charge is, as a general principle, enforceable in the chargor's insolvency, subject to certain limitations contained in insolvency law which are discussed in part 10 of the Code. The proceeds of sale of the charged asset are therefore generally available to the chargee to pay the secured debt. The chargee does not need to stand in line with the unsecured creditors.
- 5 The key thing about a charge is therefore that it creates a proprietary interest, not just a personal one. And because the concept of a proprietary interest is not always readily understood, it was thought necessary to attempt a description of a proprietary interest in **section 2.2**.
- 6 The description in **section 2.2** is based on that given by Hohfeld in *Fundamental Legal Conceptions as Applied in Judicial Reasoning*⁶.

⁶ Yale University Press, 1919

- 7 The basic distinction between a personal and a proprietary interest is that a personal interest is enforceable against a person, or a group of people, whereas a proprietary interest is enforceable against everyone, or at least most people. The problem is that a personal interest can be enforceable against more than one person and a proprietary interest does not need to be enforceable against everyone. So where is the line drawn?
- 8 Where a person creates a proprietary interest over an asset, what distinguishes a proprietary interest from a personal one is that a personal interest can only be enforced against the person who created it. In contrast, a proprietary interest can bind other people who become involved with the asset in some way – for instance by acquiring it.⁷
- 9 But a proprietary interest does not have to be enforceable against everyone in order to be proprietary. A legal interest (for instance legal ownership or a legal mortgage) will, as a general principle, be enforceable against everyone. An equitable interest will not be enforceable against a *bona fide* purchaser of the legal interest in the asset for value and without notice of the equitable interest. But an equitable interest is still a proprietary interest because it is enforceable against people other than the person who created it. Indeed, even a mere equity (such as a power to rescind) is a proprietary interest because it is enforceable against anyone other than a *bona fide* purchaser of a legal or equitable interest in the asset concerned.⁸
- 10 Where the interest is created by operation of law, what distinguishes a personal from a proprietary interest is that a personal interest can only be enforced against the person against whom the interest was created (for instance the original owner of the property concerned), whereas a proprietary interest can be enforced against others who come into contact with the asset (for instance subsequent owners). Again, it is not necessary to be a proprietary interest that it can be enforced against everyone. What is important is that it can be enforced against people other than those again whom the interest was initially created.
- 11 This is relevant in the context of priorities, which are discussed in part 8 of the Code. But its main importance in practice is that, because it is a proprietary interest, a charge

⁷ The importance of the distinction is illustrated in *National Provincial Bank v Ainsworth* [1965] AC 1175.

⁸ *Latec Investments v Hotel Terrigal* (1965) 113 CLR 265.

can be enforced against an insolvency officer of the chargor⁹. Although a personal right will abate *pari passu* with all other personal rights in insolvency proceedings of the chargor, a proprietary interest will be effective in the insolvency, subject to the limitations imposed by insolvency law which are discussed in part 10 of the Code.

- 12 In practice, this means that a proprietary interest such as a charge remains effective in the chargee's insolvency subject to the moratorium on enforcement in an administration, the particular rules concerning floating charges in an insolvency, and the ability of a liquidator or administrator to set aside transactions entered into in the period running up to the insolvency (the claw-back provisions in insolvency).

⁹ *Re Sharpe* [1980] 1 WLR 219 at 224 (Browne – Wilkinson J). The distinction between personal and proprietary rights in an insolvency is illustrated in the contrasting decisions of Peter Gibson J in *Carreras Rothmans v Freeman Mathews Treasure* [1985] 1 All ER 155 (proprietary interest) and *Re Andrabell* [1984] 3 All ER 407 (personal right).

3 Legal and equitable charges

3.1 A charge is a legal interest in the charged asset concerned if:

- (a) the chargee holds legal title to the charged asset; or**
- (b) the charged asset is an interest in registered land, and the charge is a registered charge at Her Majesty's Land Registry; or**
- (c) the charged asset is an interest in unregistered land, and the charge takes effect as a charge by way of legal mortgage; or**
- (d) the charge is a possessory charge (see part 7).**

A charge of this kind is described as a legal charge in this Code.

3.2 In any other case, a charge is an equitable interest. A charge of this kind is described as an equitable charge in this Code.

3.3 The rights, liberties, powers and immunities of the chargor and the chargee between themselves are the same whether the charge is an equitable charge or a legal charge. The distinction is only relevant in relation to third parties (see part 8).

Commentary

- 1 Under the existing law, an equitable charge is as effective in an insolvency as legal mortgage. Where a legal mortgage wins out over an equitable charge is in relation to priority issues between the secured creditor and third parties. As a general principle, a legal mortgage is more likely to be effective against third parties than an equitable charge.
- 2 The distinction between legal and equitable interests does also manifest itself in other ways. For instance, the default enforcement powers of a legal mortgagee are different from those of an equitable chargee. This is discussed in more detail in part 9 of the Code.
- 3 The intention behind the Code is to do away with the distinction between legal and equitable interests where that is practicable, but to retain it where necessary.

- 4 In the Code, the distinction between legal and equitable interests is therefore retained for the purpose of priority issues with third parties, but is discarded in relation to arrangements between the chargor and the chargee (**section 3.3**).
- 5 The reason the Code needs to retain the distinction between legal and equitable interests in relation to priority issues with third parties is that the Code is not a complete code of English property law. If it were that, it would be possible to establish a set of priority rules for all dealings with all assets which could, if desired, obviate the necessity to distinguish between legal and equitable interests. But the Code does not go that far. Its purpose is to codify the rules relating to the taking of security. In general (although there are certain exceptions) it does not attempt to deal with the creation of outright proprietary interests, such as ownership, leases, etc.
- 6 The Code therefore distinguishes between legal charges (**section 3.1**) and equitable charges (**section 3.2**).
- 7 A charge will be a legal charge in the four types of case described in **section 3.1**:
- The first type of case is where the chargee holds the legal title to the charged asset – for instance where there is a charge over shares and the chargee becomes the registered owner of the shares. That is not a usual means of creating security over shares, but it is possible.
 - The next type of case is concerned with registered land. Where the land is registered, a charge can only be a legal interest if it is registered as a charge at the Land Registry. The Land Registry also has procedures by which charges can be recorded by a notice. These are not legal interests under the Land Registry rules, and nor are they under the Code.
 - The Code also makes provision for legal interests in unregistered land – now of much less importance because of the requirement to register land on any disposition.
 - Finally, a charge is legal charge if it is what the Code describes a possessory charge. This is discussed in part 7 but, essentially, it represents what, under the current law, would be described as a pledge. Pledges create legal interests at common law, and this is replicated in the Code.
- 8 All other charges are equitable charges (**section 3.2**).

- 9 **Section 3.3** makes it clear that the position between the chargor and the chargee is the same whether the charge is equitable or legal. The distinction has to be drawn between legal and equitable charges for the purpose of priorities, but there is no necessity to continue to draw the distinction between the chargor and the chargee.

- 4 The chargor's equity of redemption**
- 4.1 The creation of a charge does not deprive the chargor of all of its interest in the charged asset. The chargor retains a proprietary interest in the charged asset. It is referred to in this Code as the equity of redemption.**
- 4.2 The chargor's equity of redemption is:**
- (a) the interest which the chargor had in the charged asset before the charge was created, but which is now subject to the chargee's interest under the charge; and**
 - (b) the power to extinguish the charge by extinguishing the secured obligation (for instance, by payment).**
- 4.3 Because it is a proprietary interest, the chargor's equity of redemption is not just enforceable against the chargee. Subject to the insolvency legislation, it is also enforceable against an insolvency officer of the chargee (see part 10). It can also be enforced against other persons who obtain an interest in the charged asset, the extent to which it can do so depending on the rules of property law at common law and in equity.**
- 4.4 Once the secured obligation has been extinguished (for instance, by payment), the charge is automatically extinguished. If the charge is an equitable charge, no further documentation is required. If the charge is a legal charge, the chargee must transfer the legal title to the charged asset to the chargor (or, in the case of a possessory charge, return possession of the charged asset to the chargor or as it may direct) . In either case, the chargee must execute a deed of release of the charge if so requested by the chargor.**
- 4.5 If a charge is extinguished and a payment which had been made in reduction of the secured obligation is then set aside or reduced in any way for any reason, the charge will automatically revive to secure the amount necessary to put the chargee in the same position as if the payment had not been set aside or reduced. This is the case even if the chargee has executed a deed of release except to the extent that the deed expressly overrides this provision.**

Commentary

- 1 There are two key characteristics of a charge. The first, that it gives the chargee a proprietary interest in the charged asset, is the subject of **section 2**. The second is that it is a limited interest because it secures the performance of the secured obligation. That is the subject of **section 4** and also of **section 6**.
- 2 Because a charge secures the performance of a secured obligation, it follows that the creation of the charge does not exhaust the entirety of the chargor's interest in the charged asset. The chargor has the power to discharge the charge, and thereby recover the charged asset, by paying the secured obligation. This is not just a personal right. It is a proprietary right. It is normally referred to as an equity of redemption¹⁰ and that is how it is described in the Code (**sections 4.1 and 4.2**).
- 3 The fact that the chargor's interest is a proprietary interest (**section 4.3**), is particularly important where the chargee becomes insolvent. If the chargor's only rights against the chargee were personal rights, they would abate *pari passu* with other personal rights in the chargee's insolvency. But, because the chargor's interest is a proprietary interest, it can be enforced (subject to insolvency law) against the chargee's insolvency officer. By repaying the secured obligation, the chargor is entitled to get the charged asset back from the chargee, even if the chargee is in insolvency proceedings.
- 4 If the chargor's original interest in the charged asset was an equitable interest, then its equity of redemption is necessarily an equitable interest. So if, for instance, the chargor is a beneficiary under a trust and charges its interest under the trust, its equity of redemption is an equitable interest.
- 5 If, on the other hand, the chargor originally had a legal interest in the charged asset, then the nature of its equity of redemption will depend on the nature of charge which it has created. If it creates a legal charge, the chargor's equity of redemption will be an equitable interest. If it creates an equitable charge, the chargor's equity of redemption will be a legal interest.
- 6 For example if a person who owns equipment creates a legal charge over the equipment in favour of a chargee, the chargor's equity of redemption will be an equitable interest. But, if it creates an equitable charge over the equipment, the

¹⁰ Strictly, this expression refers to a case where the chargor has transferred legal title in the charged asset and so only retains an equitable interest, but it is commonly used even where the chargor retains legal title.

chargor will retain legal title and its equity of redemption will therefore be a legal interest.

- 7 As has been seen, it is in the nature of a charge that, once the secured obligation has been discharged, the chargor re-acquires its unencumbered interest in the charged asset. **Section 4.4** is concerned with how this achieved in practice.
- 8 Under the existing law, a charge is automatically released on payment of the secured obligation. This is because no formalities are required in order to release the chargee's equitable interest. But, where there is a mortgage (whether legal or equitable), a further step is required in order for the chargor to become the unencumbered owner of the charged asset. The mortgagee must re-transfer the mortgaged asset to the mortgagor.¹¹
- 9 The Code broadly follows the same approach but draws the distinction in a different place – between legal and equitable charges. Where the charge is equitable, it is automatically released once the secured obligation has been paid. But, where the charge is legal, a further step is required in order to transfer the legal title back to the chargor. This is a formality only, and the chargee has a legal duty to do it.
- 10 In practice, the chargor (and subsequent lenders to the chargor) will want it to be clear that the charge has, in fact, been released. It is for that reason that it is ubiquitous in practice for a deed of release to be executed by the chargee. The final sentence of **section 4.4** requires the chargee to execute a deed of release if requested by the chargor.
- 11 Charges are extinguished, and deeds of release are executed, on the assumption that the payments made to the chargee will be retained by it. If, for any reason, a payment is set aside or reduced (for instance under the insolvency legislation) the chargee needs to be put back in the position as if the payment had not been made, and the charge needs to be revived to the extent necessary. This is the purpose of **section 4.5**. It overrides any deed of release unless the deed expressly provides to the contrary.

¹¹ See *Kennard v Futvoye* (1860) 2 Giff 81 at 92 to 93.

- 5 Intention**
- 5.1 The creation of a charge depends on the intention of the chargor.**
- 5.2 Under part 7, certain charges created by UK businesses must be registered with the Registrar of Companies. Charges of this kind are described as registrable charges in the Code. A registrable charge is only created on registration.**
- 5.3 In particular, the following matters are determined by the intention of the chargor:**
- (a) whether a charge has been created;**
 - (b) (subject to registration under part 7 if it is required) when a charge has been created;**
 - (c) whether a proprietary interest created by the chargor is a charge or an outright proprietary interest;**
 - (d) the identity of the chargee;**
 - (e) the identity and extent of the charged asset; and**
 - (f) the identity and extent of the secured obligation.**
- 5.4 Intention is a matter of substance, not of form.**
- 5.5 Intention is established objectively. The question is: what would a reasonable person consider the intention of the chargor to be, based on what the chargor and the other parties to the transaction concerned have written, said and done?**
- 5.6 A charge can be created by a document, but it does not have to be. If there is sufficient evidence of the objective intention of the chargor to create the charge, it can be created orally or by the conduct of the chargor (for instance by delivering the charged asset, or something representing it, to the chargee). This is subject to any formal requirements imposed by other legislation (see part 2).**
- 5.7 If the charge is created by a document, the objective intention of the chargor is established from the terms of the document in the context of any other relevant documents relating to the transaction concerned and any relevant background**

facts at the time it was entered into which are admissible in evidence for the purpose of interpreting the document.

5.8 Whether a person has created a charge is therefore decided (subject to registration under part 7 if it is required):

(a) first, by establishing, as a matter of fact, what the intention of that person is, based on what it and the other parties to the transaction have written, said and done; and

(b) secondly, by determining, as a matter of law, whether that person's intention is to create a proprietary interest in a charged asset to secure the performance of a secured obligation.

5.9 In some parts of this Code, reference is made to the intention of a person other than the chargor or to the common intention of the parties. These are also established objectively. The question is: what would a reasonable person consider the intention of that person or the common intention of the parties to be, based on what the persons concerned have written, said and done.

Commentary

- 1 Under the existing law, there are three main types of security – mortgage, pledge and charge. Mortgages can be either legal or equitable, and the choice in practice is therefore between a legal interest (under a legal mortgage or a pledge) or an equitable interest (under an equitable mortgage or a charge)
- 2 The advantage of an equitable interest over a legal interest is that it is easier to create, in the sense that there are fewer formalities. This is particularly true of a charge. The essence of a charge is the intention of the chargor to create the charge. That is a matter of substance, not of form. Mortgages and pledges require other formalities. A mortgage requires a transfer of legal or equitable title in the mortgaged asset. A pledge requires delivery of possession of the pledged asset.
- 3 The approach taken in the Code is to replace the existing forms of security interest with a new one which is based on the existing jurisprudence concerning charges and which is therefore described as a charge.
- 4 The reason why the existing forms of security interest are to be replaced by a charge is discussed in the Commentary to **section 10**.

- 5 There are two main reasons why the charge was chosen, rather than the mortgage or the pledge. The first is that a charge can be taken over almost every type of asset of any description, including future assets¹². That is also true of an equitable mortgage, but a pledge can only be taken over existing tangible movable assets¹³ and a legal mortgage can only be taken over existing assets over which legal title can be transferred¹⁴. The charge is therefore more all-embracing than a legal mortgage or a pledge.
- 6 The second reason for preferring the charge is that the key requirement for the creation of a charge is that the chargor intends to do so, and therefore that there are few formalities required.¹⁵ (Even an equitable mortgage requires the transfer of beneficial title to the asset.) The reason why formalities are eschewed as far as possible in the Code is discussed in the Commentary to **section 9**.
- 7 The purpose of **section 5.1** is to explain that the creation of a charge depends on the intention of the chargor. It is therefore primarily a matter of substance, not of form (**section 5.4**).
- 8 The ease of creation of a charge does mean that it can be created without third parties necessarily being aware that it has been created. It is for this reason that most types of charge created in a corporate context require registration against the chargor.¹⁶ The registration requirements of the Code are contained in part 7. If the charge is registrable, it is not created until it has been registered (**section 5.2**).
- 9 **Section 5.3** follows the existing law by describing the various matters relating to a charge which are determined by the intention of the chargor.
- 10 Whether or not a charge has been created is primarily a question of the intention of the chargor (**Section 5.3(a)**). This is part of a broader principle of equity that the creation of an equitable proprietary interest is determined by the intention of the person creating the interest. This is true of trusts (where the principle is that there must be certainty of intention to create a trust¹⁷), equitable assignments¹⁸ and charges¹⁹.

¹² *Holroyd v Marshall* (1861-62) 10 HLC 191.

¹³ *Coggs v Bernard* (1703) 2 Ld Raym 909.

¹⁴ Land, goods and limited classes of intangible. *Lunn v Thornton* (1845) 1 CB 379.

¹⁵ *Tailby v Official Receiver* (1888) 13 App Cas 523; *Re Kent & Sussex Sawmills* [1947] Ch 177.

¹⁶ Companies Act 2006, s 859A. This applies to companies. Equivalent provisions apply to LLPs.

¹⁷ *Mills v Sportsdirect* [2010] EWHC 1072 (Ch) at [52] to [55].

- 11 It is often important to know when a charge has been created, and that also depends on the intention of the chargor (**section 5.3(b)**). This is discussed in more detail in the Commentary to **section 8**. It is subject to the rule that if the charge is registrable charge, it is not created until it is registered.
- 12 The intention of the chargor also determines whether a proprietary interest is a charge or an outright interest (see **section 6**), the identity of the chargee (see part 5 of the Code), the identity and extent of the charged assets (see part 3 of the Code) and the identity and extent of and the secured obligations (see part 4 of the Code). See **section 5.3(c)-(f)**.
- 13 The Code refers to the intention of the chargor, not to the intention of the parties. In practice, a charge will be created as part of a transaction entered into between the chargor and chargee and, quite possibly, others. Why does the Code not refer to the intention of parties, rather than to the intention of the chargor?
- 14 The reason why the Code refers to the intention of the chargor is that it reflects the basic principle that the creation of an equitable proprietary interest depends on the intention of the putative creator of that interest. A charge is invariably created in a transaction between parties other than the chargor. The chargee will be involved. In a syndicated facility, so may the lenders. And the charge document is almost invariably drafted by the chargee's lawyers. But the question to be determined is whether, and on what basis, a person has created a proprietary interest over its asset.
- 15 That person's intention will reflect the commercial transaction and the agreement reached between the parties. But it is the act of the chargor which creates the charge, and it is the chargor's intention which is the ultimate requirement.
- 16 Intention plays a central part in English commercial law. It is the basis of contractual liability, and it is also the reason why equitable proprietary interests are created. But, in both types of case, the word "intention" has a very particular meaning. In neither case is the law generally concerned with the subjective intention of the parties to the contract or of the person purporting to create the equitable proprietary interest. There are limited circumstances in which subjective intention is relevant but, in the vast majority of cases, the law is concerned with the objective intention of the persons concerned.

¹⁸ *Tailby v Official Receiver* (1888) 13 App Cas 523 at 543.

¹⁹ *Re Kent & Sussex Sawmills* [1947] Ch 177; *Swiss Bank v Lloyds Bank* [1982] AC 584.

- 17 The law looks at what the person concerned has written, said and done and, where there is more than one person concerned, at what has passed between the parties. Based on that objective evidence, the law then establishes how a reasonable person would understand the intention of the people concerned. The actual, subjective, intention of the parties is irrelevant. What is important is how a reasonable person would understand their intention based on its objective manifestations. This is as true of the creation of equitable proprietary interests²⁰ as it is true of the creation and interpretation of contracts²¹. It is reflected in **sections 5.5 and 5.9**.
- 18 We have had a lot of discussion about whether there should be a requirement for writing. On one side is the view that a requirement for writing would add certainty to the law and, in any event reflects best practice. Attractive though this argument is, the approach of the Code is to eschew formalities. The reason for this is that, however well-intentioned the quest for the greater certainty which formalities provide, experience suggests that the effect of formalities is the refusal to give effect to something which the parties have agreed simply because they have not complied with a technicality.
- 19 An example in the related area of guarantees is the Statute of Frauds of 1677. This requires a guarantee to be writing and signed by the guarantor. It still can cause problems in practice, as the relatively recent decision of the House of Lords in *Actionstrength v International Glass Engineering*²² shows. In that case, a person entered into an oral guarantee as part of an agreement. But, because it did not comply with section 4 of the Statute of Frauds, the House of Lords held that it was not binding. The parties had reached an agreement, but it was not enforced
- 20 The problem with formalities of this kind is that they have the tendency to defeat the legitimate commercial expectations of the parties. There has been a long history of the courts finding ways around formalities of this kind²³. It is therefore considered that the best approach is not to require formalities at all except where they are required by other legislation. This is the effect of **section 5.6**.
- 21 Of course, in practice, it is expected that parties will continue to do what they have always done, which is to create charges in writing and have them signed. That is clearly the best practice.

²⁰ *Re Lehman Brothers International (Europe)* [2010] EWHC 2914 (Ch) at [225(v)].

²¹ *Reardon Smith Line v Yngvar Hansen-Tangen* [1976] 1 WLR 989 at 996.

²² [2003] 2 AC 541.

²³ *Rochefoucauld v Boustead* [1897] 1 Ch 196; *Bannister v Bannister* [1948] 2 All ER 133; *Yaxley v Gotts* [2000] Ch 162.

- 22 If the charge is created by a document, **section 5.7** describes the way in which that document is to be interpreted. This simply reflects the underlying law concerning the interpretation of contracts.²⁴
- 23 **Section 5.8** reflects existing law. Because it is particularly relevant to cases where a charge is distinguished from an outright interest, it is discussed in more detail in relation to **section 6.4**.

²⁴ *Investors Compensation Scheme v West Bromwich Building Society* [1988] 1 WLR 896; *Arnold v Britton* [2015] AC 1619.

6 Distinguishing a charge from an outright interest

- 6.1 What distinguishes a charge from an outright proprietary interest is that the chargee's proprietary interest in the asset concerned secures the performance of a secured obligation; and is therefore extinguished once the secured obligation has been extinguished (for instance, by payment).**
- 6.2 Whether or not a proprietary interest in an asset does secure the performance of a secured obligation depends on the legal rights, liberties, powers and immunities of the parties to the transaction, not on the economic or functional effect of the transaction.**
- 6.3 The determination of those legal rights, liberties, powers and immunities depends on the intention of the person creating the interest. Intention is established objectively.**
- 6.4 Whether a proprietary interest created by a person is a charge or an outright proprietary interest is therefore decided:**
- (a) first, by establishing, as a matter of fact, what the intention of that person is, based on what it and the other parties to the transaction have written, said and done; and**
 - (b) secondly, by determining, as a matter of law, whether that person's intention is, or is not, to secure the payment of a secured obligation.**

Commentary

- 1** It has been seen from **section 2.1** that a charge is proprietary interest in a charged asset which secures the performance of a secured obligation. The purpose of **section 6** is to explain how to distinguish a proprietary interest which secures the performance of a secured obligation from an outright proprietary interest.
- 2** **Section 6.1** effectively restates the principles in **sections 2 and 4**.
- 3** **Section 6.2** establishes that the test of whether a proprietary interest is outright or by way of security is a legal test, not an economic one. This might be thought to self-evident, but for the fact that, under the influence of jurisprudence from the United

States, a number of (mainly common law) jurisdictions have adopted a functional economic test of whether a proprietary interest is outright or by way of security.²⁵

- 4 The pros and cons of that approach are discussed elsewhere. The Code does not go down this functional route. It continues the approach of the existing law, which is that whether or not a proprietary interest is an outright interest or a charge depends on the legal rights and powers of the parties to the transaction²⁶.
- 5 **Section 6.3** establishes the principle that the determination of legal rights depends on the objective intention of the person concerned. This is consistent with **section 5.5** and with the basic approach of English law.
- 6 Whether a proprietary interest is an outright interest or a charge therefore depends on the legal position of the parties under the relevant transaction. This is essentially a matter of determining the intention of the person creating the interest, based on what the parties have written, said and done.
- 7 **Section 6.4** establishes that categorisation is a two stage process. This reflects the current law on questions such as whether a charge is fixed or floating²⁷, or whether an interest in land is a licence or lease.²⁸ The first thing to do is establish, as a matter of fact, what is the objective intention of the person who has created or transferred the interest concerned, based on what has passed between the parties. Having established this factual matter, there is then a legal decision to be made. Is the intention to transfer an outright interest to the transferee or to secure the payment of a secured obligation? A document can be expressed to create an outright interest, but nevertheless create a security interest if, based on its proper interpretation, it shows that the intention of the relevant party was that the interest concerned should secure the payment of a secured obligation²⁹. In other words, the label is not determinative.
- 8 This can be clarified by a simple example. A owes a debt to B. B transfers an asset to A. It is the objective intention of B which will determine whether the interest which has been created in favour of A is an outright interest or an interest by way of security. If

²⁵ This is the effect of Personal Property Security Acts in jurisdictions such as Canada, New Zealand and Australia.

²⁶ *Lloyds and Scottish Finance v Cyril Lord Carpets Sales* [1992] BCLC 609; *Welsh Development Agency v Export Finance Company* [1992] BCLC 148.

²⁷ *Re Brumark Investments (Agniew v Commissioner of Inland Revenue)* [2001] 2 AC 710.

²⁸ *Street v Mountford* [1985] 1 AC 809.

²⁹ *Orion Finance v Crown Financial Management* [1996] 2 BCLC 78.

B's objective intention is that the asset is to secure the payment of the debt, then it will be a charge, however it is described. But, if it is an entirely separate transaction, which is not intended to secure the debt, then it will be an outright transfer.

- 9 The most important criterion in practice is the nature of the consideration for the transfer. If A pays for the asset, then it is likely to be an outright sale, unconnected with the underlying debt. If A does not pay any consideration, then it is much more likely to be a charge. In a commercial setting, it is unlikely to be a gift.
- 10 There is another possibility, which is that the consideration for the transfer is the discharge of the debt. If that is the case, the transaction is outright, not by way of security. It is of the essence of a secured transaction that A has two rights – first, a right to payment and, secondly, a proprietary interest in an asset which secures that payment. If the consideration for the transfer is the discharge of the debt, then there can be no secured liability, A has only one right, and the transaction must be outright.
- 11 It is also important to distinguish between the creation and the retention of an interest. If A creates an interest over an asset in favour of B to secure an obligation, then a charge has been created. But if B owns an asset and creates a limited interest in favour of A (such as a leasehold interest) or if B sells an asset to A on reservation of title terms, A never obtains anything other than a limited interest in the asset and therefore cannot create a charge over it. B's rights in the asset are retained by it, not created by A. So there is no question of a charge being created by A even if, in the case of a reservation of title clause, the purpose of B retaining title is to secure the payment of the purchase price. A has not created an interest in an asset in favour of B, and so no charge has been created. This is the case under the existing law³⁰, and it is also true under the Code (**section 1.1**).
- 12 The following examples illustrate the application of **section 6**.

13 Example 1:

A leases an asset to B for the period of its useful life in consideration for the payment of rent, the amount of which approximates to the price of the asset and the cost of financing it over the period of the lease. If A's objective intention is to create a lease, the transaction is not a charge, even if it has a similar economic effect. A has created

³⁰ *Clough Mill v Martin* [1985] 1 WLR 111; *Armour v Thyssen Edelstahlwerke* [1991] 2 AC 339

an outright limited proprietary interest in favour of B. A has retained a residual proprietary interest. B has not created any interest.

14 Example 2:

A sells goods to B on the basis that A reserves title to the goods until their price has been paid. If A's objective intention is to sell goods on reservation of title, the transaction is not a charge even if it has a similar economic effect. This is also the case if A transfers legal title to B, but retains beneficial title (and, to the extent that there is any existing rule to the contrary, it is abolished). A has created an outright limited proprietary interest in favour of B. A has retained a residual proprietary interest. B has not created any interest.

15 Example 3:

B sells its receivables to A on the basis that A has recourse to B for bad debts. If B's objective intention is to sell the receivables to A, the transaction is not a charge even if it has a similar economic effect. B has transferred a proprietary interest in the receivables to A, but the interest which it has transferred is outright, not by way of security.

16 Example 4:

A sells goods to B on the basis that B will lease them back to A. If the parties' objective intention is that B will acquire the goods and then lease them to A, the transaction is not a charge even if A remains in possession of the goods and the transaction has a similar economic effect to a charge. The transactions are outright, not by way of security.

17 Example 5:

A sells goods to B on the basis that the payment of the price is deferred, that A reserves title to the goods until they are sold and that, on sale, B holds the proceeds of sale on trust for A. The proceeds of sale belong to B, and accordingly the proprietary interest which A obtains in them is created by B; it is not retained by A. The trust over the proceeds of sale is a charge if B's objective intention is that the trust secures the payment of the price.

18 *Other examples will be added to clarify the application of this section in practice, including title transfer of financial collateral, such as repos.*

PART 2: CREATION

7 Creating a charge

- 7.1 A charge is created if the chargor intends to create a charge (see part 1). This will be the case if the chargor intends to create a proprietary interest over a charged asset to secure the performance of a secured obligation. Intention is established objectively (see part 1).
- 7.2 Under part 7, certain charges created by UK businesses must be registered with the Registrar of Companies. Charges of this kind are described as registrable charges in the Code. A registrable charge is only created on registration.
- 7.3 The Code distinguishes between:
- (a) the charge, which is the proprietary interest in the charged asset; and
 - (b) the charge instrument, which is the document, words, act or other thing which creates or evidences the charge.
- 7.4 The charge instrument may be a contract between the chargor and the chargee or it may be a unilateral act of the chargor.
- 7.5 The charge instrument may create personal obligations on the chargor (or the chargee) in addition to the proprietary interest in the charged asset constituted by the charge.
- 7.6 The charge instrument may be in writing, but it does not have to be.

Commentary

- 1 **Section 7.1** establishes that a charge is created if that is the objective intention of the chargor. This largely reiterates what is said in part 1 of the Code. **Section 7.2** reiterates that a registrable charge is not created until it is registered. The reason for repeating these things here is so that the key elements of the creation of a charge are all stated in part 2.
- 2 **Section 7.3** draws a distinction between:
 - the charge; and

- the charge instrument.
- 3 A charge is defined in **section 2.1** as a proprietary interest in a charged asset which secures the performance of a secured obligation. A charge is therefore a legal construct.
 - 4 As **section 5** shows, a charge is created by the intention of the chargor. That intention needs to be reflected in an objective way – normally by a document signed by the chargor but, sometimes, by words, acts or other things which create or evidence the intention of the chargor to create the charge. The charge instrument is therefore the objective manifestation of the charge.
 - 5 In most cases, the charge instrument will be a written contract between the chargor and the chargee, but it is possible for a charge to be created by the unilateral act of a chargor without there being a contract – for instance by the delivery of goods to the chargee under a possessory charge.
 - 6 The result is that the charge instrument may be a contract, and it may be in writing, but it does not have to be either. This is the effect of **sections 7.4 to 7.6**.
 - 7 The reason for drawing the distinction between the charge and the charge instrument is a practical one.
 - 8 Part 7 of the Code provides for the registration of most charges created by UK businesses. A registrable charge is not properly created until it has been registered.
 - 9 It follows that, in order for a registrable charge to be created, two things need to happen:
 - (a) first, there needs to be some objective manifestation of the intention of the chargor to create the charge (normally by the chargor signing a document); and
 - (b) secondly, the charge needs to be registered at Companies House.
 - 10 Although the charge itself is not created until registration, it does not follow that the charge instrument is of no effect at all. If it is a contract between the chargor and the chargee (and, in practice, it normally will be) it will often contain personal contractual obligations on the chargor in addition to the charge itself. There may, for instance, be undertakings and representations in the charge. These will normally come into effect

when the charge instrument is entered into, even if the charge itself is not created until registration.

- 11 It is for this reason that the Code draws a distinction between the charge and the charge instrument. It is particularly important in relation to the time of creation, which is the subject of **section 8**.
- 12 It is worth explaining, at this juncture, why the Code requires registration of a registrable charge before the charge itself is created.
- 13 Under the existing law, registration is required of most charges created by companies. This is a substantive requirement of the creation of effective security. It is not just a formality. It is essentially a counterpoise to the ease of creation of security in equity. Because it is so easy to create security between a chargor and a chargee, registration is needed in order to notify third parties of the existence of a security, so that they can plan their dealings with the chargor accordingly.
- 14 The combination of the ease of creation of security and the requirement for registration in most commercial transactions creates an efficient system. It works well in practice.
- 15 But the current system does have one inherent flaw. The parties have 21 days within which to register the security. This means that there will be period of time during which the charge has been created but is not registered. In theory, this could lead to third parties being misled. This has not proved to be a particular problem in practice, but the purpose of the Code is to simplify and clarify the law, and it was therefore felt important to deal with this issue.
- 16 The approach which has been adopted is that the registration of the charge is a constituent part of its creation, so that the charge is not created until it has been registered. The advantage of this approach is that it is simple: no registration, no charge.³¹ It will only work if the chargee receives confirmation of registration as soon as it delivers the relevant documents to the registrar. This point is discussed further in the Commentary to part 7.
- 17 The Code therefore draws a distinction between the charge and the charge instrument. The charge is not created until it is registered, if it is a registrable charge. But the charge instrument is created when it is entered into and, if it contains personal obligations on the part of the chargor (or, indeed, other parties), then they will be

³¹ This is broadly the same approach that is taken in relation to registrable charges in Scotland.

effective in accordance with the terms of the charge instrument even before registration.

- 18 The personal obligations created by the charge instrument become effective once the charge instrument has been entered into. But the charge itself – the proprietary interest in the charged asset - is only created once it is registered if the charge is a registrable charge.
- 19 Not all charges are registrable. If the charge is not registrable then it is created as soon as the charge instrument is entered into, unless it is not intended to take effect until some later time.
- 20 Two examples can illustrate the position.
- 21 A charge created by a company over land is a registrable charge. If the chargor creates a charge over land, the personal contractual obligations of the chargor are binding on it as soon as the charge instrument has been validly entered into. But, the charge itself – the proprietary interest in the charged asset – only becomes effective once the charge has been registered at Companies House.³²
- 22 A financial collateral charge is not registrable at Companies House. Accordingly, as soon as the charge instrument has been validly entered into, the charge itself is created. Nothing else is required.
- 23 The purpose of this approach is to make the charge as transparent as possible. Where the charge is not registrable, all that is required is that the charge instrument has properly been entered into. But, in the vast majority of cases in a commercial transaction, the charge will be registrable. And the charge itself will not be created until it has been registered.

³² A further registration may be made at the Land Registry. This does not affect the validity of the charge, but it does affect its priority. See the Commentary to part 8 of the Code.

8 Time of creation

8.1 This section is concerned with the time of creation of:

- (a) the charge instrument;**
- (b) any personal obligations of the chargor or others under the charge instrument; and**
- (c) the charge.**

8.2 The time of creation of the charge instrument depends on the general law. Accordingly, if the charge instrument is a contract, it depends on the common intention of the parties; and, if the charge instrument is a unilateral act, it depends on the intention of the chargor.

8.3 If the charge instrument is a contract, the time at which the personal obligations of the chargor or other parties to the contract are created depends on the law of contract. Accordingly, it depends on the common intention of the parties.

8.4 If the charge is not a registrable charge, it is created when the chargor intends it to be created.

8.5 If the charge is a registrable charge, it is created once:

- (a) the chargor intends it to be created; and**
- (b) it is registered under part 7 of the Code.**

8.6 Intention is established objectively (see part 1).

Commentary

1 Time of creation is very important in practice, and **section 8.1** distinguishes between the creation of three different things:

- (a) the charge instrument;
- (b) personal obligations under the charge instrument; and
- (c) the proprietary interest under the charge.

- 2 The time of creation of the charge instrument is a matter for the general law. So, if it is a contract, it depends on the common intention of the parties; and, if it is a unilateral act, it depends on the intention of the chargor (see **section 8.2**).
- 3 In practice, a charge instrument will normally be a contract, and it is likely to contain personal obligations on the chargor in addition to the creation of the charge - such as undertakings and representations. The time of creation of these personal obligations is determined under the general law. It therefore depends on the common intention of the parties (see **section 8.3**). Normally they will be created when the charge instrument is created, but in some cases they may not be created until later.
- 4 When it comes to the time of creation of the charge itself, the Code does not simply follow the general law. It alters it. It does so because of the requirement to register most charges created by UK businesses, which is contained in part 7 of the Code.
- 5 For the reasons which are discussed in the Commentary to **section 7**, where the charge is a registrable charge, it is not validity created until it has been registered under part 7 of the Code.
- 6 In the result, the time of creation of a charge depends on whether or not it is a registrable charge. If it is not a registrable charge, it is created when the chargor intends it to be created (**section 8.4**). But, if it is a registrable charge, it is not created until it has been registered under part 7 (**section 8.5**).
- 7 An example can help to clarify how this works in practice.
- 8 A company wishes to borrow money from its bank and to create security in favour of the bank to secure the repayment of the loan. Accordingly, it enters into a charge instrument in favour of the bank. The charge instrument creates a charge over the company's assets in favour of the bank. It also contains certain undertakings in favour of the bank which regulate how the security will be operated.
- 9 The first question is when the charge instrument is created. The time at which this happens depends on the general law – in this case the law of contract.
- 10 In many cases, the parties will intend the charge instrument to be entered into when the last person signs, in which event it will be created at that time. Alternatively, the charge instrument may be executed but held “as undelivered” until the happening of a future event. In this case, the charge instrument is not created until the event occurs. Alternatively, the charge instrument may be held “in escrow” in which event, under

Section 895E of the Companies Act 2006, it is created immediately if it is a deed. (This is curious result, and consideration should be given to changing it so that, if the charge instrument is held in escrow, it is not created until it comes out of escrow.)

- 11 The second question is when the personal obligations of the chargor under the charge instrument are created. The time at which this happens depends on the general law – again, the law of contract. It will therefore depend on the common intention of the parties. Some obligations may be subject to a condition precedent, in which event they are not created until the condition has been satisfied. But in most cases the intention of the parties will be that the obligations of the chargor are created as soon as the charge instrument is created.
- 12 The final question is when the charge itself is created. In some cases, the charge will not be registrable – for instance if it is a financial collateral charge. In this type of case, the charge is created when the chargor intends it to be created. The chargor may not intend the charge to be created until the happening of some future event. But, in practice, it would normally be the case that the intention of the chargor is to create the charge as soon as the charge instrument is created. If that is the case, the charge is created at the same time as the charge instrument is created.
- 13 In most cases, a charge created by a UK business will be registrable, and it is here that the Code does alter the underlying law. If the charge is a registrable charge it is not created until it is registered. It is intended that the registration process should be straightforward and electronic and, accordingly, that there should not be any significant gap between the creation of the charge instrument and its registration. In addition, it is intended that there should be a priority notice system which will enable the charge to be registered in advance. This is discussed in the Commentary to part 7 of the Code.

9 Formalities and other requirements

- 9.1 This Code does not contain any formal requirements for the creation of a charge (such as the necessity for writing, a deed or signatures).**
- 9.2 To the extent that other legislation prescribes formal requirements for the creation of a charge, those requirements must be complied with unless they are overridden by the Code; and failure to do so has the consequences prescribed by the legislation concerned.**
- 9.3 Under part 7, certain charges created by UK businesses must be registered with the Registrar of Companies. This is a matter of substance, not of form. A charge of this kind (known in the Code as a registrable charge) is only created on registration.**
- 9.4 Where a charge is created over an asset which is registrable in an asset registry, failure to register the charge in the asset registry does not affect the validity of the charge, although it may affect the priority of the charge against other proprietary interests in the asset concerned (see part 8).**
- 9.5 If a charge is a financial collateral charge (see part 7), certain provisions of the Code do not apply to it, including the requirement for registration under part 7 and, on an insolvency of the chargor, certain of the provisions of part 10. In order to qualify as a financial collateral charge, the charge must be created or arise under a security financial collateral arrangement, as that expression is defined in the Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003/3226) as amended from time to time.**

Commentary

- 1** The approach of the Code is that there should be no formal requirements for the creation of a charge. The reasons for this approach are discussed in the Commentary to **section 5**.
- 2** **Section 9.1** sets out this basic philosophy. It is not necessary because it is simply a negative statement. But it was thought to be helpful for the reader that the principle be expressed. The creation of a charge is a matter of objective intention. There are no formalities.

- 3 Although the Code does not itself impose formalities, there is other legislation which does impose formalities which do apply to charges. One example is section 53(1)(c) of the Law of Property Act 1925, which requires a disposition of an equitable interest to be in writing and signed. **Section 9.2** acknowledges that formalities contained in other legislation may apply to charges.
- 4 The alternative would be to override the legislation in the case of charges. The advantage of this approach is that it would do away with all formalities, but it might be thought that this goes too far, particularly in relation to land (although there could be an exception for land). Views on this would be welcome.
- 5 **Section 9.3** is concerned with registration at Companies House. It is discussed in the Commentary to **section 7**. This is not a formality. It is a matter of substance.
- 6 **Section 9.4** is concerned with those types of charge which are registrable at asset registries such as HM Land Registry. Failure to register at an asset registry does not affect the validity of the charge, but it does affect its priority against other encumbrances. This is a matter of priorities rather than formalities, and is discussed in the Commentary to part 8 of the Code.
- 7 If a charge is a financial collateral charge, some of the provisions of the Code are varied (for instance, the requirement for registration). There are additional requirements for a charge to be a financial collateral charge, which are set out in the relevant legislation. See **section 9.5**.

10 Recharacterisation

- 10.1 A charge is now the only type of security interest which can be created by a person under English law.**
- 10.2 Mortgages, security assignments, pledges and contractual liens can no longer be created, but will be treated as charges.**
- 10.3 Accordingly, if:**
- (a) A purports to:**
 - (i) transfer a proprietary interest in an asset to B, or,**
 - (ii) create a proprietary interest over an asset in favour of B; and**
 - (b) that proprietary interest secures the performance of a secured obligation, then it is a charge, regardless of its characterisation by the parties.**
- 10.4 This section does not affect:**
- (a) [*Cape Town mortgages*]; or**
 - (b) security which arises by operation of law; or**
 - (c) security created before the Code came into force.**

Commentary

- 1 The purpose of the Code is to simplify the law. One of the problems with the current law is that there are three main types of security interest available – mortgages, charges and pledges; and mortgages can be either equitable or legal. There is therefore a multiplicity of types of security.
- 2 This can be seen as an advantage – a multiplicity of types of security enables parties to exercise choice. But, in practical reality, there is little difference between the various types of security interest except in one respect – which is whether they are legal or equitable. And even that is more relevant to priority issues than to anything else.
- 3 So the reality of the current law is that there are a variety of different ways of doing the same thing. That seems unnecessary complicated.

- 4 The intention behind the Code is to take the best parts of the current law and turn them into a single form of security interest – the charge. The charge is based largely on its namesake, but the Code does recognise that, for priority reasons, a legal interest can be important, and there is therefore provision for legal as well as equitable charges (see the Commentary to **section 3**).
- 5 There would be no point in creating a new form of charge and then allowing the existing forms of security to continue. That would create complication, not resolve it. The intention of the Code is therefore that the charge will replace the existing forms of security.
- 6 As a result, if a person purports to create any other form of security interest, it will be treated as a charge, and be subject to the provisions of the Code. This is the effect of **sections 10.1 to 10.3**.
- 7 The following examples illustrate the application of this principle.
- 8 Example 1:

If A purports to pledge goods to B (or to create a contractual lien over them in favour of B), B's interest will be a charge, and not a pledge (or lien).
- 9 Example 2:

If A purports to mortgage an asset to B, B's interest in the asset will be a charge, not a mortgage.
- 10 Example 3:

If A purports to assign an intangible to B in order to secure the payment of a secured obligation, B's interest in the intangible will be a charge, not an assignment.
- 11 It is now possible to create a Cape Town mortgage over aircraft. This is not affected by the Code, and this is reflected in **section 10.4(a)**. It may be necessary to add other international or foreign registries to this list.
- 12 **Section 10.4(b)** reiterates what is said in **section 1.3** that the Code is concerned with consensual security interests, not those which arise by operation of law.

- 13 It is intended that Code be brought into force by a statute. The Code will not affect security created before it came into force, and the implementing legislation will contain transitional provisions. See **section 10.4(c)**.

PART 3: CHARGED ASSETS

11 Charged assets in general

- 11.1** The charged asset can be any interest which the chargor has, or may have in the future, in property of any kind (whether or not it is located in England or governed by English law).
- 11.2** The interest which the chargor has in the property can be any collection of rights, liberties, powers and immunities which is capable of being transferred or over which a proprietary interest can be created.
- 11.3** The interest does not, therefore, have to amount to ownership. It can be legal or equitable. It can be outright or by way of security.
- 11.4** The charge instrument must identify the charged asset. What this requires is that, when the charge comes to be enforced over an asset, it is possible to establish whether or not that asset falls within the scope of the charged asset described in the charge instrument. It is not necessary to do so at any earlier stage.
- 11.5** A person can create a charge over the benefit of a charge (in other words, a sub-charge).
- 11.6** A person can create a charge in favour of a chargee over a receivable owing by the chargee to the chargor.
- 11.7** A company's uncalled capital is property of the company and can be charged by it.
- 11.8** Any number of charges can exist concurrently over the same asset.
- 11.9** In this Code, property is, for certain purposes, divided into:
- (a)** land: which means land and fixtures;
 - (b)** goods: which means any tangible asset which is transferable by delivery, other than fixtures; and
 - (c)** intangibles: which means any property other than land or goods (and some intangibles may constitute financial collateral).

Commentary

- 1 The Code applies to property of all kinds – land as well as goods and intangibles. See **section 11.1**.
- 2 This is because, in practice, one charge is frequently taken over a number of different types of asset. A common form of security interest is the debenture by which a chargor charges all of its present and future assets.
- 3 It is also because the basic issues of security law are the same whatever type of asset is charged – who can create the charge and how, who can be the chargee, what are the charged assets, what are the secured liabilities, how is the security to be enforced?
- 4 There are of course differences between land and other assets, but there are also very material differences between goods and intangibles. In neither case do they affect the basic principles of taking security. It was therefore considered that no useful purpose would be served by confining the scope of the Code to assets other than land³³.
- 5 The Code therefore applies to all property of all kinds; and it also applies wherever the property is located and, if it is an intangible asset, whichever law governs it. Conflict of laws rules in England or elsewhere will determine the extent to which it will be enforced over foreign property but, as a matter of English substantive law, the Code applies to all property (see **section 11.1**).
- 6 Although the Code applies to all types of property, it is sometime necessary to draw distinctions between different types of property. **Section 11.9** draws a distinction between land, goods and intangibles. Sometimes it is necessary to delve further into each of these types of property. For instance, **section 15** is concerned with receivables, which are a sub-category of intangibles.
- 7 In common parlance, we talk about a person creating a charge over land, or goods, or a contract right. There is nothing wrong with that, but it is not strictly accurate. A chargor does not create a charge over property. The chargor creates a charge over its interest in the property. In the case of land for instance, it is not the land which is charged; it is the chargor's freehold or leasehold interest which is charged. This is reflected in **sections 11.1 and 11.2**.

³³ Which is what has been done in the United States and the PPSA jurisdictions which follow it.

- 8 The interest concerned does not have to be ownership. It can be legal or equitable; and it can be outright or by way of security (see **section 11.3**). Any interest can be charged if it can be transferred or a proprietary interest can be created over it (see **section 11.2**).
- 9 So, for example, a chargor can charge its leasehold interest in property, or a security interest which it has in property. The only restriction is that a charge cannot be created over a purely personal right – in other words a right which cannot be transferred or over which a proprietary interest cannot be created. So if, for instance, a particular receivable is personal to its owner, it cannot be charged because it can neither be transferred and nor can a proprietary interest be created over it. A charge is a type of proprietary interest, and it cannot be created if a proprietary interest cannot be created. **Section 16** deals with intangibles which cannot be charged.
- 10 All legal systems require charged property to be identified, but what is meant by “identification” differs between legal systems. English law takes a very expansive view of identification, as can be seen from the decision of the House of Lords in *Tailby v Official Receiver*³⁴. At the time the charge is created, it is not necessary to establish what will eventually fall within its scope. So long as it is possible to identify the charged assets at the time the charge comes to be enforced, then there is sufficient certainty of subject matter. See **section 11.4**.
- 11 **Section 11.5** illustrates **section 11.3**. A charge can be created over the benefit of a charge.
- 12 **Section 11.6** has been inserted for the avoidance of doubt. In *Re Charge Card Services*³⁵, it was decided that it was conceptually impossible for a person to have a charge over a debt which it owes to another. That decision was disapproved by the House of Lords in *Re Bank of Credit and Commerce International (No. 8)*³⁶. It is therefore possible for a person to take a charge over its own debts. **Section 11.6** confirms this position.
- 13 In *Re Russian Spratts Patent*³⁷, it was decided that uncalled capital is not property of a company and, as a result, a security document must specifically refer to uncalled

³⁴ (1888) LR 13 App Cas 523.

³⁵ [1987] Ch 150.

³⁶ [1998] AC 214.

³⁷ [1898] 2 Ch 149.

capital if the security is to extend to it. The purpose of **section 11.7** is to reverse this decision. A reference to the property of a company will include the company's uncalled capital. This is not expected to have much effect in practice because companies rarely have uncalled capital.

- 14 For the sake of completeness, **section 11.8** repeats **section 1.4**.

12 Future assets

- 12.1 A chargor can create a charge over any interest which it may subsequently have in property. An interest of this kind is described as a future asset in this Code.
- 12.2 A charge over a future asset is an equitable charge.
- 12.3 If a charge instrument is expressed to charge future assets, the charge will automatically extend to each future asset concerned once the chargor obtains an interest in the property concerned, without the necessity for any other act by the chargor or for any further registration under part 7.
- 12.4 A chargor can therefore create a charge over all or any part of its interest in its present and future assets.
- 12.5 A chargor's future assets include assets which it acquires after it has entered into insolvency proceedings. But an asset recovered in insolvency claw-back proceedings (see part 10) is not an asset of the chargor and accordingly cannot be charged by the chargor.

Commentary

- 1 **Section 12** is concerned with future assets. It builds on **section 11**.
- 2 **Section 12** generally reflects the existing law. It is not possible to create a legal mortgage over future assets. At common law, the mortgaged asset must be in existence and owned by the mortgagor at the time the mortgage is created³⁸. But it is possible to create an equitable mortgage or charge over future property³⁹. Once the asset comes into existence and becomes owned by the chargor, it automatically becomes subject to the equitable mortgage or charge without anything further being required to be done⁴⁰.
- 3 Under the existing law, a charge over future property is only effective if it is given for consideration. This is because an equitable proprietary interest is only created over future property if there is a binding contract to create it.⁴¹ This is not a requirement under the Code. In practice there will normally be consideration for the creation of a

³⁸ *Lunn v Thorton* (1845) 1 CB 379.

³⁹ *Holroyd v Marshall* (1861-62) 10 HLC 191.

⁴⁰ *Collyer v Isaacs* (1881) 19 ChD 342 at 351.

⁴¹ *Holroyd v Marshall* (1861-62) 10 HLC 191.

charge but, in the interests of simplicity, it was not considered necessary to impose this additional requirement.

- 4 One of the questions which has created problems in practice is the extent to which a charge over future assets covers assets which are acquired by the chargor after it has entered into insolvency proceedings. The Code deals with this issue by drawing a distinction between assets which are recovered as a result of the insolvency claw-back provisions (which are discussed in part 10 of the Code), and other assets. The former are intended to be recovered for the benefit of creditors as a whole, and so they do not fall within the scope of the charge. But any other assets which are subsequently acquired by the company do fall within the scope of the charge. This suggested approach has been put forward for discussion.

13 Part of an asset

- 13.1 A charge can be created over part of an asset if that part which is charged is identifiable.
- 13.2 A charge over a particular percentage or proportion of an asset is identifiable. Unless the charge instrument provides to the contrary or the parties agree to the contrary, the chargee is entitled to all of the proceeds of the asset concerned until the chargee has received an amount equal to its percentage or proportion.

Commentary

- 1 **Section 13.1** confirms that a charge can be taken over a part of an asset provided that it is identifiable. Identifiability is discussed in the Commentary to **section 11.4**.
- 2 Identification can be a particular problem with a part of an asset. If I charge 20 of my 100 shares in ICI, would the charged assets be sufficiently identifiable? Issues of this kind have created problems in relation to the creation of trusts. The problem can be solved by the courts treating a trust of 20 per cent of an asset as if it were a trust of 100 per cent of the asset on behalf of the settlor as to 80 per cent and the beneficiary as to 20 per cent.⁴² But it is more difficult to apply that logic to a charge.
- 3 **Section 13.2** deals with this issue by providing a rebuttable presumption that, where there is a charge over a particular percentage or proportion of an asset, the asset is identifiable and the chargee is entitled to all the proceeds to the asset until the chargee has received an amount equal to its percentage or proportion. This is a default rule. Like much else in the Code, it gives way to contrary intention.

⁴² *Hunter v Moss* [1994] 1 WLR 452; *Re Lehman Brothers International (Europe)* [2010] EWHC 2914 (Ch), [232].

14 Extent of charged assets

- 14.1 The extent of the charged assets is determined by the objective intention of the chargor (see part 1). Where the charge is created by a document, this depends on the interpretation of the document.**
- 14.2 A charge over an asset extends to the proceeds of an unauthorised disposition of that asset to the extent that they are capable of being traced.**
- 14.3 A charge over an asset extends to:**
- (a) the benefit of any insurance contract for the benefit of the chargor relating to that asset; and**
 - (b) where the asset consists of a right to receive money, any security for that right, whether that security is proprietary (such as a charge) or personal (such as a guarantee); and**
 - (c) where the asset consists of the benefit of an account, the benefit of any replacement account,**
- except to the extent that the charge provides to the contrary or the parties agree to the contrary.**
- 14.4 A charge over land extends to fixtures on the land.**

Commentary

- 1 Section 14.1** states the basic principle, which has been seen in **section 5**, that the extent of the charged assets is a matter of the objective intention of the chargor. Where, as will usually be the case, the charge is created by a document, it therefore depends on the proper interpretation of the document concerned.
- 2 Section 14.2** states the underlying law. It is a reminder that, where there is an unauthorised disposition of a charged asset, the chargee may be able to trace the asset into its proceeds. Whether it can do so depends on the rules of tracing, normally in equity.
- 3 Section 14.3** establishes three default rules, which give way to contrary intention.

- 4 Under the existing law, the general principle is that a charge over an asset does not extend to the proceeds of any insurance taken out in respect of the asset⁴³. **Section 14.3(a)** alters this. The default rule is now that a charge over an asset will extend to the benefit of any insurance contract for the benefit of the chargor relating to the asset.
- 5 Where the charged asset is a right to receive money, the question that sometimes arises is whether the charge extends to any security granted for that right. A charge over a receivable will normally be expressed to extend to any security for the receivable. **Section 14.3(b)** establishes a default rule that a charge over a right to receive money does include any security for that right.
- 6 It is common for charges to be taken over bank accounts, and also for money standing to the credit of one account moved to a replacement account. **Section 14.3(c)** establishes a default rule that, where the asset consists of the benefit of an account, the charge extends to the benefit of any replacement account.
- 7 **Section 14.4** states the underlying law - that a charge over land extends to fixtures on the land.

⁴³ *Sinnott v Bowden* [1912] 2 Ch 414 at 419; *Lees v Whiteley* (1866) LR 2 Eq 143; *Colonial Mutual v ANZ* [1995] 1 WLR 1140.

15 Receivables

- 15.1 A receivable is the right which one person (the payee) has to be paid money by another person (the payer). The right can arise under a contract or in any other way; and it can be present, future or contingent. It includes a debt and a claim for damages.**
- 15.2 If a payee creates a charge over a receivable, the chargee obtains all of the payee's rights in relation to the receivable until the charge is extinguished, subject to the terms of the charge instrument and the provisions of this Code.**
- 15.3 It is not a requirement for the creation of a charge over a receivable that notice of the charge is given to the payer. But notice may be given if the parties to the charge wish.**
- 15.4 For the purpose of this section, a payer only has notice of a charge if it is actually aware of it. No formalities are required, but constructive notice is not sufficient.**
- 15.5 Until the payer has received notice of a charge, it will obtain a good discharge by paying the payee or as the payee has directed. Once the payer has received notice of a charge, it can only obtain a good discharge by paying the chargee or as the chargee has directed.**
- 15.6 To the extent that, as a result of payment, the chargee receives more than is necessary to pay the secured obligations, it holds the balance on trust for the chargor under the equity of redemption (see part 1).**
- 15.7 Once the payer has received notice of a charge, the chargee can bring legal or arbitration proceedings in its own name against the payer without the involvement of the chargor, except to the extent that the chargee has directed the payer to pay someone else. To the extent necessary to resolve the proceedings, the tribunal concerned will join the chargor to the proceedings; and any costs of doing so are payable by the chargee (although it may recover them from the payee if the payee has agreed to pay them or is otherwise liable for them).**
- 15.8 The chargee obtains no greater rights to the receivable than the payee has. For instance, if the payment of the receivable is subject to a condition or to a right of**

set-off under the contract, then the chargee is subject to them in the same way as the payee is.

15.9 In addition, the payer can set off against the chargee any cross-claim which it has against the payee if:

(a) the cross-claim arises under a contract or other transaction entered into before the payer has received notice of the charge (even if the cross-claim was future or contingent at the time notice was received); or

(b) the cross-claim is so closely connected with the chargee's claim against the payer that it would clearly be unfair for it not to be taken into account.

15.10 The rights, powers, liberties and immunities of the payer, the payee and the chargee under this section can be varied by agreement between the relevant parties.

15.11 *Provisions relating to specific types of asset can be addressed here if required, for instance in relation to registered land, ships and aircraft, intellectual property and particular categories of goods and intangibles.*

15.12 *For instance:*

Aircraft Equipment

To the extent that a charge is created over an asset to which the International Interests in Aircraft Equipment (Cape Town Convention) Regulations 2015/912 apply, this Code is subject to those Regulations.

Commentary

1 Although the basic principles concerning charged assets are the same, whatever the nature of the asset concerned, there are particular rules which apply to particular types of asset. Where practicable, it is intended to state these rules in the Code. We start with receivables, but specific reference could be made to assets such as registered land, ships and aircraft, intellectual property and particular categories of goods and intangibles.

- 2 **Section 15.1** defines receivables broadly, to include any right which one person has to be paid money by another. The second two sentences of **section 15.1** show that the intention is to give the expression a broad meaning.
- 3 If a charge is created over a receivable, the chargee will generally obtain all of the payer's rights in relation to the receivable until the charge is extinguished. This is the subject of **section 15.2**. This principle is subject to the other provisions of the Code, particularly those set out in the rest of **section 15**. It is also subject to the provisions of the charge instrument. It is open to the parties expressly to restrict the rights of the chargee, and therefore the general principle in **section 15.2** will give way to contrary intention.
- 4 Under the existing law, a statutory assignment of a receivable requires notice to be given to the payer.⁴⁴ But an equitable assignment or charge can be created without any notice being given to the payer.⁴⁵ **Section 15.3** adopts the equitable rule. A valid charge can be created over a receivable without notice being given to the payer.
- 5 It will no longer be possible to take a statutory assignment where the interest being acquired by the assignee is a security interest (see **section 10**). A purported assignment by way of security will be treated as a charge. But the ability of the chargee to bring proceedings in its own name in certain circumstances is preserved by **section 15.7**.
- 6 Although notice of a charge is not a requirement of its validity, it can still be given, and it can be advantageous (for instance under the rule in *Dearle v Hall*⁴⁶). For some purposes, constructive notice may be sufficient. But **section 15.4** provides that, for the purpose of **section 15**, a payer only has notice of a charge if it is actually aware of it.
- 7 One of the practical issues which arises where a charge has been created is whom the payer must pay in order to obtain a good discharge. Until the payer has received actual notice of the charge, it clearly has to pay the chargor. It is not aware of anyone else. If the payer pays the chargor in ignorance of the creation of a charge, it will still get a good discharge.⁴⁷ The Code does not alter this. See **section 15.5**.

⁴⁴ Law of Property Act 1925, s 136.

⁴⁵ *Gorringe v Inwell India Rubber and Gutta Percha Works* (1886) LR 34 ChD 128.

⁴⁶ (1828) 3 Russ 1.

⁴⁷ *Stocks v Dobson* (1853) 4 De GM&G 11.

- 8 But, in practice, it is common for a notice to be given to the payer which directs the payer to continue to pay the chargor until it receives notice to the contrary from the chargee. **Section 15.5** also caters for this. Until the payer has received a direction to pay the chargee, it will obtain a good discharge by paying the chargor. Once the payer has received a direction to pay the chargee, it can only obtain a good discharge from the chargee.
- 9 **Section 15.6** deals with the situation where the chargee receives more than it is entitled to. In such a case, as with any chargee, it holds the balance on trust for the chargor. This is an application of the chargor's equity of redemption established in **section 4**.
- 10 **Section 15.7** is concerned with the practicalities of the chargee bringing legal proceedings against the payer. It adapts the underlying law. Once the payer has received notice of the charge, the chargee can bring proceedings in its own name against the payer unless it has been directed to pay someone else (for instance, the chargor). If it is necessary to resolve the proceedings, the tribunal will join the chargor to the proceedings, and the costs are for the account of the chargee, although the charge instrument itself may enable the chargee to be reimbursed by the chargor.
- 11 The rights of a chargee of a receivable derive from those of its chargor. It follows that the chargee can have no greater rights to the receivable than the chargor has. If an amount is only payable on the satisfaction of certain conditions, then those conditions apply as much to the chargee as they do the chargor. If a payment is subject to contractual right set-off, then it will apply to the chargee as much as to the chargor⁴⁸. This principle is stated in **section 15.8**.
- 12 **Section 15.9** is concerned with other rights of set-off. Because a chargee of a receivable takes its interest in the receivable "subject to equities", the chargee is subject to another limitation on its rights. Even if money is payable under the contract, the chargee may find the amount to which it is entitled is reduced because the payer has a right of set-off against the chargor and it is entitled to exercise it against the chargee.
- 13 For instance, the payer may have entered into other dealings with the chargor as a result of which money is payable by the chargor to the payer. The payer may be able to set these amounts off against the chargee if it could have done so against the

⁴⁸ *Tooth v Hallett* (1868-69) LR 4 Ch App 242.

chargor. Although there would be no mutuality in such a case, set-off would be available because the assignee takes “subject to equities” and the right of set-off is an “equity”.

- 14 Under the general law, the payer would be entitled to a set-off in a case of this kind if the payer would have had a right of set-off against the chargor at the time it received notice of the charge. It would have such a right in two circumstances. First, if the cross-claim was liquidated or of a certain amount at that time (although it need not necessarily have been payable then). And secondly if the cross-claim was so closely connected with the payer’s claim against the chargor that it would clearly be unfair for it not to be taken into account.⁴⁹
- 15 **Section 15.9** broadly adopts the same approach. The one change is in **section 15.9(a)**. Under the underlying law, a set-off is only available of unconnected claims if the cross-claim was liquidated and was either presently payable or must become payable in the future (ie if it was a present or a future claim) at the time notice was received. It does not apply where the claim was contingent at that time (ie it was an existing claim the payment of which was dependent on the happening of some uncertain future event). Under **section 15.9(a)**, a set-off is available even where the claim was contingent at the time the notice was given. So if, at the time the payer received notice of the charge, it had already entered into a contract with the chargor, then amounts payable under that contract can be set-off against the chargee even if they were contingent at the time notice was received. We think that this strikes a fairer balance, but it is, of course, subject to discussion.
- 16 One of the basic precepts of the Code is that the parties should have as much freedom to contract as possible. **Section 15.10** is an example of this approach. The parties can vary the rules contained in **section 15**.

⁴⁹ *Business Computers v Anglo-African Leasing* [1977] 1 WLR 578; *Bank of Boston Connecticut v European Grain & Shipping* [1989] AC 1056; *Geldof Metaalconstructie v Simon Carves* [2010] 1 CLC 895.

16 Prohibitions on charging certain intangible assets

- 16.1** The benefit of an intangible asset (for instance, a contract) cannot be charged if it is prohibited by the terms on which the asset is created (for instance, the terms of the contract which creates it), unless it is permitted by other legislation (such as the Small Business, Enterprise and Employment Act 2015).
- 16.2** This is the case even if the prospective chargee is unaware of the prohibition.
- 16.3** Whether or not the creation of a charge is prohibited by the terms of a contract is a matter of interpretation of the contract concerned. The question is whether it is the common intention of the parties that the putative charge is prohibited. Intention is established objectively (see part 1).
- 16.4** If the terms of a contract do prohibit the creation of a charge over all or any part of the benefit of a contract, then:
- (a)** unless it is permitted by other legislation, any purported charge is, to the extent of the prohibition, invalid; and
 - (b)** if the chargor has agreed to create the charge, the invalidity of the charge may result in a personal claim by the intended chargee against the chargor.
- 16.5** In this Code, a prohibition on the creation of a charge includes any limitation of any kind on the creation of the charge (including, for instance, the requirement for a consent which has not been obtained).
- 16.6** This section does not apply to a contract which creates a proprietary interest in land or goods (for instance, a lease of land).

Commentary

- 1 It is common for contracts to contain prohibitions on the creation of charges (and, indeed, of assignments). What is the effect of those provisions? If a charge is created in breach of such a prohibition, is the charge invalid, or is it just that the person who has breached the contract is liable in damages?
- 2 The Code draws a distinction between two types of case. **Section 16** is concerned with intangible assets the terms of which prohibit the creation of a charge. **Section 17** is concerned with other contractual restrictions.

- 3 The most obvious example of a restriction to which **section 16.1** applies is a contract right. A enters into a contract with B under which A agrees to pay money to B in consideration for the supply of services by B. The contract prohibits B from creating a charge over the benefit of the contract. In breach of that restriction, B charges to C its rights under the contract, including the receivable owing by A. Is the charge valid?
- 4 The effect of **section 16.1** is that the charge is invalid unless it is validated by other legislation.
- 5 The Code follows the approach in the existing law. The key decision is that of the House of Lords in *Linden Gardens Trust v Lenesta Sludge Disposals*⁵⁰. B's rights against A are created by contract. The only asset which B has is its contractual right against A. It should therefore follow that B's rights against A are determined by the terms of the contract. And if the contract says that it cannot be charged, then it cannot be charged. Any purported charge is a nullity.
- 6 This approach has much to commend it. A and B have entered into a contract under which A is assured that B cannot charge its rights under the contract, and therefore that A is solely responsible to B. That being the basis on which the parties have contracted, should it be open to B to deny that the clause has the effect which the parties have agreed?
- 7 But this approach does have its critics. The argument is that receivables are an important asset available to a company, and that it should be able to assign or charge them freely whatever the terms of the contract are between A and B. The argument is essentially one of expediency, rather than logic. The need to raise finance on receivables is so important, that the contractual arrangements between the parties should be overridden in the greater interests of the UK economy.
- 8 It was this idea which led the government to pass the Small Business, Enterprise and Employment Act 2015. It contains a power for regulations to be made to override contractual restrictions on assignment. The regulations have not yet been finalised, and so it is not clear precisely what the terms of the legislation will be. The primary legislation only applies to assignments, and it is not clear whether this will also encompass charges. **Section 16.1** is expressed to be subject to the Act, but it remains to be seen the extent to which it will affect charges.

⁵⁰ [1994] 1 AC 85.

- 9 The problem with the approach in the Small Business, Enterprise and Employment Act 2015 is that it overrides the contractual arrangements between the parties. If A enters into a contract with B to pay money in consideration for the receipt of services, A may have an interest in dealing only with B, and not with anyone else. And A does not want to find itself in a position where, as a result of the creation of a charge in favour of C in breach of a contractual prohibition, it has to pay more to C than it would have had to pay B. This would be a possible outcome because, although the contractual entitlement of C (as chargee) is no greater than that of B (as payee), the effect of the charge to C may be that A loses rights of set-off which it would have been able to exercise against B. Set-off is discussed in the Commentary to **section 15.9**. Although A's rights of set-off against B are available against C, it is only those in existence at the time when A received notice of the assignment. If A is dealing on running account with B, an assignment to C could prejudice A's rights.
- 10 The countervailing argument is that it is in the interest of the UK economy that B should be able to raise money on its receivables, and that it is therefore appropriate to override contractual restrictions.
- 11 It would be possible to reconcile these two imperatives if the law recognised that:
- a purported charge/assignment of a receivable is effective to give the chargee/assignee a proprietary interest in the receivable; but
 - the payer has no duty to pay the chargee/assignee more than it would have had to pay its counterparty, so enabling it to take advantage of any rights of set-off which would have arisen if there had been no charge/assignment.
- 12 This alternative approach was explored in an Annexure to the first version of the Code (July 2015). It applied not just to charges but also assignments, although it would be possible to restrict it to charges. We would welcome views on this.
- 13 **Section 16.2** provides that the rule described in **section 16.1** applies even if the prospective chargee is unaware of the restriction. That follows the existing law.
- 14 One of the issues which has caused the most difficulty in practice has been determining whether a particular form of words does, or does not, apply to the particular transaction which has been effected. For instance, if a clause prohibits an

assignment, does it also prohibit a charge or a trust? Much of the recent case law on this area has been concerned with this issue⁵¹.

- 15 But these cases are of limited value because they decide what a particular formulation of words meant in a particular contract. Any question of contractual interpretation depends on the precise words used in the context of the contract as a whole, any other transaction documents, and the relevant background facts at the time the transaction was entered into. The meaning of a prohibition in particular words in one transaction is not necessarily the same as the meaning of those words (or similar words) in another transaction at a different time.
- 16 **Section 16.3** confirms that the meaning of a particular restriction is a matter of interpretation. It would be nice if it could resolve some of these questions of interpretation, but it cannot do so. Ultimately, the only people who can do so are the draftsmen of the contracts concerned.
- 17 **Section 16.4** explains the effect of these provisions in a transaction and **section 16.5** gives a wide meaning to the expression “prohibition”.
- 18 The application of **section 16** can be illustrated in the following example.

If:

- (a) A has entered into a contract with B under which B is entitled to a receivable from A;
- (b) the contract contains a prohibition on B creating a charge over the receivable without A’s consent;
- (c) A has not consented; and
- (d) B purports to charge the receivable to C,

then:

- (a) unless the prohibition is ineffective under other legislation, the purported charge is invalid, and C therefore obtains no proprietary interest in the receivable; and
- (b) C may have a personal claim for breach of contract against B, depending on the terms of its contract with B.

⁵¹ *Don King Productions v Warren* [2000] Ch 291; *Barbados Trust Co v Bank of Zambia* [2007] 1 CLC 434.

- 19 **Section 16.1** is concerned with intangible assets where the terms on which the asset is created prohibit the creation of a charge. **Section 16.6** makes it clear that this does not apply to a contract which creates a proprietary interest in land or goods. The most obvious example is a lease of land.

17 Other contractual prohibitions on charging assets

17.1 Neither the validity nor the priority of a charge over an asset is affected by any contractual prohibition on the creation of a charge by a chargor, except to the extent that it is invalidated under the preceding section.

17.2 This is the case even if the chargee is aware of the prohibition.

17.3 This does not affect any personal claim for breach of contract which the chargor may be liable for.

17.4 If:

(a) a chargor creates a charge over an asset; and

(b) a person with a proprietary interest in that asset has the benefit of a contractual prohibition on the creation of such a charge; and

(c) when taking the charge, the chargee had actual knowledge of that prohibition and deliberately encouraged the chargor to breach it,

then the chargor is liable in tort for the loss suffered by the person in whose favour the prohibition was given. The chargor has no other liability of any kind (for instance, in tort or in equity) if it takes a charge in breach of a contractual prohibition on its creation.

Commentary

1 **Section 17** is concerned with contractual prohibitions on the creation of a charge which do not fall within **section 16**. Here, the rule is the opposite to that in **section 16**. The validity of a charge over such an asset is not affected by a contractual prohibition on the creation of a charge. And this is the case even if the chargee is aware of the prohibition (**section 17.2**).

2 The reason for this distinction is that assets of this kind exist in their own right – not merely because they have been created by a contract. There is therefore no necessary reason why a breach of the prohibition should prevent the creation of a charge.

3 The approach taken in the Code is to create one simple rule, which is that a prohibition of this kind can give rise to a personal claim for breach of contract (**section 17.3**), but

that the validity of the transaction itself cannot be called into question (**section 17.1**), even if the chargee is aware of the restriction (**section 17.2**).

- 4 If a chargee had actual knowledge of the prohibition at the time the charge was created, and it deliberately encouraged the chargor to breach that provision, the chargee may be liable in tort under **section 17.4**. But that is the limit of its liability. **Section 17.4** is intended to cut through much of the case law on unlawful interference with contracts and provide a simple test of liability which will only be satisfied in an extreme case. Whether this draws the line in the right place is a question we would like to discuss.
- 5 The effect of **section 17** can be illustrated in the following example:

If:

- (a) B is the owner of goods and agrees with A that it will not charge the goods; and
- (b) B purports to charge the goods to C,

then:

- (a) the purported charge is valid;
- (b) in the limited circumstances described in **section 17.4**, A may have a personal claim against B in tort to recover any loss which A has suffered as a result of the charge being created in breach of the prohibition (and, if it finds out in time, it may be able to get an injunction);
- (c) unless those limited circumstances apply, A will have no claim against B in relation to the charge; and
- (d) A will have a personal claim against B for breach of contract for the loss which A has suffered as a result of the charge being created in breach of the prohibition.

PART 4: SECURED OBLIGATIONS

18 Secured obligations

- 18.1 The secured obligation can be any obligation or liability of any kind of any person. It can be present, future or contingent.
- 18.2 The secured obligation does not have to be owed by the chargor. Nor does it have to be owed to the chargee.
- 18.3 The identity and extent of the secured obligation depends on the objective intention of the chargor (see part 1).
- 18.4 The charge instrument must identify the secured obligation. What this requires is that, when the charge comes to be enforced in relation to a particular obligation or liability, it is possible to establish whether or not that obligation or liability falls within the scope of the secured obligation described in the charge instrument. It is not necessary to do so at any earlier stage.
- 18.5 For example, a secured obligation may include a liability to pay all money from time to time owing:
- (a) to a particular person or class of persons; or
 - (b) under a particular agreement or class of agreements.
- 18.6 If the secured obligation is not an obligation to pay money, the charge secures the obligation to pay damages for breach.

Commentary

- 1 In a secured transaction, the identification of the secured obligations is as important as the identification of the charged assets. An elaborate description of the charged assets counts for nothing if there is not an appropriate description of the secured obligations. As **section 2.1** shows, there are two key elements to a charge. First, the chargee obtains a proprietary interest in an asset. Secondly, the proprietary interest secures the performance of a secured obligation. Each of these elements is as important as the other.
- 2 A secured obligation can be any obligation or liability of any kind of any person (see **section 18.1**). The formulation is very wide.

- 3 **Section 18.2** establishes that the secured obligation does not have to be owed by the chargor. This is important in practice. A chargor can charge an asset in favour of a chargee not only to secure an obligation owing by the chargor to the chargee, but also an obligation owing by a third party to the chargee. A transaction of this kind is commonly referred to as “third party charge”.
- 4 If A owes an obligation to B, and it is intended that C should charge an asset in support of that obligation, there are two ways in which this can be done. C can guarantee the obligations of A to B, and then charge its asset to B in support of that guarantee (and the guarantee can be limited to the value of the charged asset if that is what is required). Or, alternatively, C can charge the asset in favour of B to secure A’s obligations to B. In this latter case, C owes no personal obligation to B. So B cannot bring proceedings against C for the recovery of the amount owing. Instead, C has created a proprietary interest in favour of B which secures the obligation which A owes to B. Although C is not personally liable to pay the liability, B is entitled to enforce the charge in order to recover the amount owing by A. Unlike the guarantee example, a third party charge is necessarily limited recourse – limited to the value of the asset charged.
- 5 **Section 18.2** also establishes that the secured obligation need not be owed to the chargee. A charge can be created in favour of someone else (for instance a trustee) on behalf of the creditor. See **section 22**.
- 6 One of the great advantages of the English law of secured transactions is that the identity and extent of both the charged assets and the secured obligations is a matter for agreement between the parties. This is reflected in **section 18.3**, and it is discussed in more detail in part 1.
- 7 Another advantage of English law is that, although it is necessary to identify the charged assets and the secured obligations, it is not necessary to do so at the outset of the transaction, but only when the charge comes to be enforced. In the case of the charged assets, this is provided for in **section 11.4**. In relation to secured obligations, it is contained in **section 18.4**.
- 8 In practice, it is common for secured obligations to fall into one of two categories (see **section 18.5**).
- 9 Where there is only one lender involved (in other words, it is a bilateral facility), it is common for the secured obligations to be expressed to be all moneys from time to time

owing by the chargor to the chargee. This means what it says. It will cover not just those facilities which are in place at the time the charge is created, but also subsequent facilities granted by the chargee to the chargor.

- 10 The extent of the secured obligations depends on the interpretation of the particular words used in the context of the charge instrument and the other transaction documents as a whole and in the context of the relevant background facts at the time the transaction was entered into.
- 11 In a bilateral transaction, it is common for the secured obligation to be expressed to be all moneys and liabilities now or hereafter owing or incurred by the chargor to the chargee “on any account whatsoever”. In *Re Quest Cae*⁵², wording of this kind was held to extend only to money which had been lent or otherwise made available by the chargee to the chargor. It did not cover money which had been lent by a third party and which had subsequently been acquired by the chargee. That was because the reference to “any account whatsoever” must have been intended to cover dealings or transactions between the chargor and the chargee, but not liabilities incurred by the chargor to a third party which had subsequently been acquired by the chargee.
- 12 For this reason, it is common for the secured obligations clause specifically to refer to amounts acquired by the chargee as well as amounts owing to the chargee.
- 13 A typical “all moneys” clause would contain an undertaking by A to pay all money due or owing to B and all obligations or liabilities incurred to B, whether they are:
 - (a) present, future or contingent;
 - (b) joint or several;
 - (c) payable as a principal debtor or as a guarantor;
 - (d) sounding in debt or in damages;
 - (e) originally owing to B, or originally owing to a third party but which have been acquired by B.
- 14 All moneys clauses are common in bilateral facilities but not in syndicated facilities. Where the loan is made available by a number of lenders, all moneys wording would extend not just to the facility concerned, but also to any other facilities which any of the

⁵² [1985] BCLC 266.

lenders might make available to the borrower. For that reason, it is usual for the secured obligations to be expressed to be all moneys from time to time owing under the particular facility agreement concerned.

- 15 This does cause practical problems. The chargor creates a charge over its assets to secure all moneys owing under a particular facility agreement. That facility agreement is then amended. Does the security cover the amended facility?
- 16 As would be expected, this is a question of interpretation of the secured obligations clause. The secured obligations definition will almost invariably cover all moneys owing under the facility agreement “as it may be amended from time to time”. If it does, then this security will extend to an amended facility.
- 17 But that does not necessarily solve all the problems. There is concern in practice that the amendments may be so fundamental that, although drafted as an amendment to the existing facility, they really create a new facility. If that is the case, the secured obligations clause will not cover what has happened. In *Triodos Bank v Dobbs*⁵³ a guarantee was held not to extend to an amendment to a facility agreement which was in substance a new facility, even though it was drafted as an amendment to an existing facility. The concern in practice is that this principle would be applied to security documents.
- 18 It is therefore quite common for a secured obligations clause to cover:
- all money from time to time owing under [a particular facility agreement], including all amounts owing under that agreement as it may be amended from time to time, even if the agreement is fundamental (for instance, by increasing the amount of the facility to any extent, by changing the purpose of the facility concerned or by changing the identity of the persons providing the facility).
- 19 When drafting the Code, it was considered whether wording along these lines could be inserted in the Code itself – in effect as a presumption of what the parties would intend, but subject to contrary intention. It was decided that this would be too great an intrusion, and that it is necessary to leave the question to the interpretation of the document concerned.
- 20 For that reason, **section 18** does not attempt to do anything other than to state that the extent of the secured obligations is a matter of interpretation.

⁵³ [2005] 2 CLC 95.

- 21 Secured obligations normally comprise obligations to pay or repay money. If the secured obligation is an obligation to perform a non-monetary obligation, **section 18.6** provides that the amount secured is the amount of damages payable for breach of the primary obligation.

- 22 This is because the chargor's equity of redemption is one of the fundamental aspects of a charge. When the charge is enforced, it is necessary to establish the amount of the secured obligation in order to ascertain the extent of the chargor's equity of redemption.

PART 5: THE PARTIES TO A CHARGE

19 The parties

- 19.1 The parties to a charge consist of the chargor (who creates the charge) and the chargee (in whose favour the charge is created).
- 19.2 A charge instrument must be executed by the chargor, or the chargor must agree to it in some other way.
- 19.3 It is not necessary for the chargee to execute a charge instrument unless the charge instrument contains an obligation on the chargee and the agreement of the chargee to that obligation is evidenced by its execution of the instrument. Section 2 of the Law of Property (Miscellaneous Provisions) Act 1989 is amended accordingly.
- 19.4 Other persons may be parties to a charge instrument.
- 19.5 The same charge instrument may contain more than one charge.

Commentary

- 1 The purpose of **section 19** is largely to state the obvious – who the parties to a charge are, and who needs to execute a charge instrument.
- 2 **Section 19.1** describes the chargor and the chargee.
- 3 In **section 7.4**, the Code draws a distinction between the charge itself (the proprietary interest in an asset which secures a secured obligation), and the instrument by which the charge is created. The latter is described in the Code as a charge instrument. It will normally be a document, but it does not have to be.
- 4 In practice, it is common for a charge to be created in a separate charge instrument which deals only with the creation of the charge and with ancillary matters. But charges can be created in documents to which other people are parties (**section 19.4**) and, sometimes, one charge instrument can be used to create a number of different charges between different parties (**section 19.5**).
- 5 **Sections 19.2 and 19.3** deal with the execution of charge instruments.

- 6 A result of section 2 of the Law of Property (Miscellaneous Provisions) Act 1989, an agreement to dispose of land must be contained in a document, which must be executed by the chargor and the chargee. Under the existing law, a charge over future land (ie land in which the chargor does not yet have a proprietary interest) is only effective in equity because it is an agreement to create a charge⁵⁴. It follows, therefore, that a charge over future land must comply with the provisions of the Act. Any document which contains a charge over future land (including a debenture) must therefore be executed both by the chargor and by the chargee.
- 7 **Sections 19.2 and 19.3** alter this. Under the Code, a charge instrument only needs to be executed by the chargor. It is the chargor, not the chargee, who creates it, and it is no longer necessary for a contract to create a charge over future assets (see the Commentary to **section 12**).
- 8 It is not common for charge instruments to contain obligations by the chargee. The chargee has a duty to retransfer the charged property to the chargor on discharge of the charge, but this is a legal obligation, independent of any contractual duty to do so - see **section 4.4**. If a charge instrument does contain obligations by the chargee, then it needs to be executed by the chargee or the agreement of the chargee needs to be evidenced in some other way. See **section 19.3**.

⁵⁴ *Holroyd v Marshall* (1861-62) 10 HLC 191.

20 The chargor

20.1 A charge can be created by any person, subject to the limitations contained in this part and to any limitations contained in other legislation.

21 Resident natural persons as chargors

21.1 A resident natural person cannot create a charge over goods (whether they are in the United Kingdom or elsewhere) unless:

- (a) the goods are owned by the chargor at the time the charge is created; or**
- (b) the chargor is carrying on business as a sole trader and the charged assets do not extend beyond the assets of the business concerned; or**
- (c) the chargor is a member of a partnership or a limited partnership and the charged assets do not extend beyond the assets of the partnership concerned.**

21.2 A resident natural person is a natural person who has lived in the United Kingdom for at least 200 days in the 365 days immediately preceding the creation of the charge.

Commentary

- 1 These are some of the most controversial provisions of the Code, and have provoked a lot of discussion.
- 2 There is no disagreement on what the starting point should be – that a charge should be capable of being created by any person, whether a natural or a legal person. **Section 20** provides for this.
- 3 The problems come when deciding whether there should be any exceptions from this principle and, if so, what they should be.
- 4 There are two distinct questions at issue, although they are often linked in practice. The first is whether there should be any limits on the ability of natural persons to create security, particularly if they are consumers. The second is whether all security created by all persons (whether legal or natural) should be registrable at a debtor registry.

- 5 These issues are conceptually distinct. But they have been linked historically for over a century because of the distinction which legislation has drawn between security created by companies (and now LLPs) and security created by natural persons. In essence, companies can create security over all their present and future assets and, if they do so, the security must generally be registered at Companies House in order to ensure its validity. In theory, natural persons can create security over all their present and future assets but, in practice, the effect of the bills of sale legislation is that non-possessory security over goods is extremely difficult for natural persons to create because of the formidable registration requirements. The effect is that individuals can create security over land and over most types of intangible (the main exception being a general assignment of book debts) but not, generally, over goods unless they create a pledge.
- 6 It has long been considered that the bills of sale legislation is unsatisfactory and the Law Commission is now considering the question of its replacement. It has been consulting on it, and a final report is expected to be published in the summer of 2016.
- 7 Anything which the Code does in this area must take cognizance of what the Law Commission proposes and what the Government accepts. The proposals in the Code must therefore be tentative at this stage.
- 8 **Section 21** prevents resident natural persons from creating security over goods, unless the security falls within one of the exceptions, contained in the section.
- 9 There are exceptions for natural persons who are running a business, either in partnership (**section 21.1(c)**) or as a sole trader (**section 21.1(b)**).
- 10 The other exception (contained in **section 21.1(a)**) is that a natural person should be able to create a charge of goods if they are owned by him or her at the time the charge is created. This would prevent chargors from being able to create security over future goods.
- 11 These restrictions only apply where the natural person concerned is resident in the United Kingdom (see **section 21.2**). The intention here is to establish an element of territoriality to match that for charges created by businesses (see part 7).
- 12 These issues are still at the discussion stage, and further debate on this issue is welcomed. In particular, there is still concern that there is insufficient protection here for consumers, and that their ability to create security should be circumscribed further.

22 The chargee

22.1 The chargee can be:

- (a) the creditor or creditors to whom the obligation secured by the charge is owed (the creditors); or
- (b) another person (such as a trustee) for the benefit of the creditors.

22.2 A person can hold the benefit of a charge on behalf of any number of present, future or contingent creditors.

22.3 The rights, powers, liberties and immunities of that person and the creditors between themselves can be established and varied by agreement between them.

[Consider partnerships, trustees and agents as chargors.]

[Transfers?]

Commentary

- 1 It is commonplace for a debtor to create security over an asset in favour of its creditor. In this type of case, the chargor creates security in favour of the chargee to secure a secured obligation owing by the chargor to the chargee. This common form of charge is the subject of **section 22.1(a)**.
- 2 But it is also very common, particularly in syndicated loans and capital markets transactions, for the security to be granted in favour of someone (such as a security trustee) for the benefit of the creditors from time to time under a particular transaction. This is the subject of **section 22.1(b)**.
- 3 The use of security trustees to hold the security on behalf of a group of creditors has a number of advantages. Where there are a number of creditors involved, granting the security to all of them is administratively inconvenient and, from the point of view of the chargor, undesirable. Even more importantly, syndicated loans are designed to be traded, so that the identity of the syndicate will change from time to time. In syndicated loans, the trading is normally effected by novation, (rather than assignment); and, if the security was granted to all of the lenders, new security would need to be granted in favour of each new lender when it joined the syndicate.

- 4 The advantage of the security trust structure is that the security is created at the outset of the transaction in favour of a security trustee on behalf of a group of lenders, the identity of whom can change from time to time. A change to the underlying lenders does not require any change to the security. The security continues to be granted to the same person (the security trustee) and it continues to secure what it has always secured (the obligations of the borrower to the lenders from time to time under the facility).
- 5 A security trustee can hold the benefit of a charge for the benefit of any number of present or future or contingent creditors (**section 22.2**).
- 6 The touchstone of the Code is the ability of the parties, so far as possible, to agree things between themselves. **Section 22.3** applies this principle to the rights of the creditors between themselves.

PART 6: THE TERMS OF A CHARGE

23 The terms

23.1 Subject to the provisions of this Code and of any other relevant laws and regulations (such as those concerning consumers), the terms of the charge can be agreed between the parties from time to time.

23.2 For instance, subject to those limitations, the parties can agree:

- (a) the rights, liberties, powers and immunities of the parties before enforcement;
- (b) the chargee's powers of enforcement; and
- (c) the rights, liberties, powers and immunities of the parties on and after enforcement.

Commentary

- 1 One of the purposes of the Code is to give the parties as much freedom as possible to determine the terms of the arrangement between them. They cannot alter the basic principles of property law (for instance the requirement for identification of the charged assets and the secured obligations), but the Code expressly acknowledges their freedom under the general law to agree the terms of the charge subject to the provisions of the Code and of any other relevant laws and regulations (for instance those dealing with consumers).
- 2 This is the subject of **section 23.1**. It is elaborated on in **section 23.2**.
- 3 It is common for charges to distinguish between the rights and powers of the parties before and after enforcement. This is the reason for **section 23.2**.

24 Default powers

- 24.1 The respective powers of the chargor and the chargee to deal with the charged assets during the continuance of the charge can be agreed between the parties in accordance with the preceding section.**
- 24.2 In the absence of agreement, the chargor has the power to deal with the charged assets in any way (including by taking possession of them, using them, receiving income from them, charging them or disposing of them) until the charge is enforced, except that the chargor cannot:**
- (a) where the chargor carries on a business, dispose of outright, or create an outright proprietary interest over, any of the charged assets which are fixed assets (see part 8);**
 - (b) where the chargor does not carry on a business, dispose of outright, or create an outright proprietary interest over, any charged assets;**
 - (c) take possession of assets which are the subject of a possessory charge; or**
 - (d) deal with the charged assets fraudulently (in the sense of dishonestly).**
- 24.3 In the absence of agreement, the chargee has no power to deal with the charged assets until the charge is enforced**

Commentary

- 1 Under **section 24.1**, the powers of the parties to deal with the charged assets can be agreed between the parties in accordance with **section 23**.
- 2 In most cases, the charge instrument will expressly deal with these issues. But the law does need to provide default powers for cases where there is no (or incomplete) agreement. The purpose of **section 24.2** is to strike a fair balance between the ability of the chargor to deal with the charged assets and the interests of the chargee under the charge. It will only apply to the extent that the parties have not specifically dealt with the issues concerned.
- 3 The basic position under **section 24.2** is that the chargor can deal with the charged assets in any way until the charge is enforced, except for the matters specified in that section. The corollary, in **section 24.3**, is that the chargee cannot deal with the charged assets in any way until enforcement.

- 4 Under **section 24.2(a)**, where the chargor carries on a business (which will normally be the case in a commercial transaction), the chargor cannot sell fixed assets or, in any other way, dispose of them outright or create an outright proprietary interest over them. This is intended to give effect of the basic principle that, where the asset is a fixed asset, it would not be expected that the chargor should be able to dispose of it without the consent of the chargee.
- 5 **Section 24.2(a)** does not mention charges. Consideration was given to whether the chargor should (subject to contrary agreement) be precluded from creating a charge over fixed assets, and it was decided that the default position should be that there is no limitation on the power to charge, so that this would need to be dealt with expressly in the charge instrument. The priority of the charges is dealt with in part 8.
- 6 Where the chargor does not carry on a business (for instance where it is a consumer), the default position is more restrictive. Under **section 24.2(b)**, it is not entitled to dispose of outright, or create a proprietary interest over, any charged assets.
- 7 The last two paragraphs of **section 24.2** are of less general significance. **Section 24.2(d)** states what would be the case anyway – that the chargor cannot deal with the charged assets fraudulently (in the common law sense of dishonesty). **Section 24.2(c)** deals with possessory charges. Unless the parties agree otherwise, the chargor cannot retake possession of assets which are the subject of a possessory charge. That is inherent in the nature of a possessory charge (as with a pledge).
- 8 These are all default rules, and they give way to contrary agreement.

25 Clogs on the equity of redemption

- 25.1 The doctrine of “clogs” on the equity of redemption is abolished to the extent that it limits the freedom of the parties to a charge to determine its terms.**
- 25.2 For example, neither of the following is invalid solely on the ground that it is a clog on the equity of redemption:**
- (a) an option for the chargee to purchase charged assets; or**
 - (b) an undertaking by the chargor in favour of the chargee which extends beyond the period of the charge.**
- 25.3 This does not affect the chargor’s equity of redemption in the charged asset, including the ability of the chargor to recover the charged assets once the secured obligation has been extinguished (see part 1).**

Commentary

- 1 It is a fundamental principle of the existing law of security that the chargor retains a proprietary interest in the charged asset (normally referred to as an equity of redemption) and that, once the secured obligations have been discharged, the charge terminates and the chargee must take any necessary action to transfer the charged assets back to the chargor. This is preserved in the Code - see **section 4**. Nothing in **section 25** alters this fundamental principle (see **section 25.3**).
- 2 In a series of cases in the House of Lords at the end of the nineteenth century and the beginning of the twentieth, it was decided that “any provisions inserted to prevent redemption on payment or performance of the debt or obligation for which the security was given is what is meant by a clog or fetter on the equity of redemption and is therefore void”.⁵⁵
- 3 The effect of this rule is that an undertaking by the chargor in favour of the chargee which extends beyond the period of the charge⁵⁶ and an option for the chargee to purchase the charged assets⁵⁷, are both void.

⁵⁵ *Santley v Wilde* [1899] 2 Ch 474 at 474-475. And see *Bradley v Carritt* [1903] AC 253 and *Kreglinger v New Patagonia Meat and Cold Storage Co* [1914] AC 25.

⁵⁶ *Noakes v Rice* [1902] AC 24.

⁵⁷ *Lewis v Frank Love* [1961] 1 WLR 261.

- 4 This extension of the principle concerning equities of redemption has been criticised⁵⁸, and seems unnecessary in a commercial transaction.

- 5 The approach taken in the Code is that, although the existence of the equity of redemption is a fundamental principle which should not be capable of being contracted out of, there is no reason why collateral arrangements of the kind described above should not be perfectly effective if that is what the parties have agreed. **Section 25.2** deals with the two specific examples described above. They are examples of a broader principle which is contained in **section 25.1** which abolishes the doctrine of “clogs” on the equity of redemption to the extent that it limits the freedom of the parties to the charge to determine its terms.

⁵⁸ See *Bradley v Carritt* [1903] AC 253 at 262 (Lord Shand).

PART 7: REGISTRATION

26 The scope of this part

26.1 This part provides for the registration of certain charges (described as registrable charges) created by UK businesses. Such charges are not created until they are registered.

26.2 It also enables the registration of charges created by UK businesses which are not registrable charges, and also of receivables financing agreements entered into by UK businesses. Charges and agreements of this kind do not require registration to be validly created, but they may be registered if the parties wish.

26.3 A UK business is any of the following:

- (a) a UK-registered company within the meaning of section 1158 of the Companies Act 2006;
- (b) a company incorporated by statute or created by Royal charter in any part of the United Kingdom;
- (c) a limited liability partnership registered in any part of the United Kingdom;
- (d) a partnership or limited partnership which is created under the law of any part of the United Kingdom;
- (e) resident natural person who is carrying on business as a sole trader.

26.4 The registrar is the Registrar of Companies.

Commentary

- 1 It has been seen in **section 8** that charges which are registrable under part 7 are not validly created until they have been registered. Once the charge instrument has been entered into, the personal obligations of the chargor are valid, but the proprietary interest created by the charge is not created until it is registered.
- 2 The main purpose of part 7 is to explain which types of charge do require to be registered at Companies House and how the registration process is effected.
- 3 It also contains a provision for the voluntary registration for receivables financing agreements (**section 35**).

- 4 **Sections 26.1 and 26.2** explain the purpose of part 7.
- 5 The registration requirements of part 7 apply to “UK businesses”. The expression “UK business” is defined in **section 26.3**. It extends more broadly than the existing requirement for registration under the Companies Act 2006, and the reason for this extension needs to be explained.
- 6 The reason why charges are registrable in a debtor registry (and, if not registered, are ineffective) is because registration is a counterbalance to the absence of any formalities for the creation of charges. The great advantage of the charge is the simplicity with which it can be created and the fact that its existence and scope generally depends on the intention of the chargor. But this very simplicity carries with it a concern that security can be created between a chargor and a chargee without anyone else becoming aware of it; and that this could prejudice third parties dealing with the chargor. The registration system provides the necessary transparency for the charge. So long as the registration system is cheap, easy to use and certain in its effect, its combination with the ease of creation of security produces a system which works well in practice.
- 7 The question is therefore now broad the registration system should be? Should it cover all charges created by anyone, or only particular types of charge created by particular types of chargor?
- 8 The proposition that the registration requirement should apply to all charges created by everyone is very appealing. But it proceeds on the assumption that registration provides the same benefits to all types of charges created by all types of person. And the view which has been adopted when drafting the Code is that there is a demonstrable need for registration in the commercial context, but less clarity about the real benefits which would be obtained if it were extended to consumers.
- 9 The Code has also been drafted against the backdrop of the current law, which provides an efficient and useful system of registration for companies, but a very inefficient system for individuals which no-one wants to retain. If we were starting from scratch with a registration system, there would be much to be said for applying it to all chargors. But the approach taken in the Code is that we already have a registration system for companies which works well in practice; and therefore that the better approach is not to require the establishment of a wholly new register but, rather, to adapt the registration system which is already available at Companies House.

- 10 The approach when drafting **section 26.3** has therefore been to retain the current system of registration which applies to charges created by companies and LLPs and to extend that to other business entities and to partnerships and sole traders.
- 11 This would seem to be manageable extension to the current registration system. But to extend it to all consumers who create security would be greatly to extend its scope without any obvious measurable commensurate benefit. The genius of English law has always been its preference for practicality over absolute logic, and this is the approach which has been adopted when drafting the registration provisions of the Code.
- 12 **Section 26.3** therefore defines a UK business to include those classes of entity whose charges already require registration (UK-registered companies (**section 26.3(a)**) and LLPs (**section 26.3(c)**). It then extends the requirement to companies incorporated by statute or created by Royal charter - an obvious inherent limitation on the existing structure – **section 26.3(b)**; and also partnerships (**section 26.3(d)**) and sole traders (**section 26.3(e)**).
- 13 The intention is that Companies House would provide a registered number to every UK business and would then register charges created by it. The other requirements of the Companies legislation would not apply to non-companies.
- 14 As with the current legislation, the registration requirement applies to UK chargors. Registration requirements for foreign chargors should depend on the law of the place they are incorporated or otherwise exist.

27 Registrable charges

27.1 Every charge created by a UK business is a registrable charge unless it is an exempt charge.

27.2 An exempt charge is:

- (a) a possessory charge; or**
- (b) a financial collateral charge; or**
- (c) a rent deposit charge; or**
- (d) a Lloyd's charge; or**
- (e) a central bank charge; or**
- (f) a charge which is exempt from registration under this Code as a result of other legislation.**

27.3 A charge is not created by a UK business if:

- (a) the charge arises by operation of law; or**
- (b) the UK business acquires an asset which is already subject to the charge;
or**
- (c) the UK business is the owner of property and, in connection with a dealing with that property, it retains an interest in the property to secure the payment of a secured obligation.**

Commentary

- 1 Section 27** describes which charges created by UK businesses are registrable charges. The starting point is that all charges created by a UK business are registrable. Those charges created by UK businesses which are not registrable are described as exempt charges in the Code.
- 2** Exempt charges are broadly the same as security interests which are not registrable under the Companies Act 2006.

- 3 Under the existing law, mortgages and charges are registrable but pledges are not. **Section 27.2(a)** therefore exempts from registration possessory charges, which are defined in **section 28**.
- 4 In practice, the main type of mortgage or charge which is not registrable under the current law is one which is exempted under the Financial Collateral Arrangements (No. 2) Regulations 2003, which implements the Financial Collateral Directive. A charge of this kind is referred to in the Code as a “financial collateral charge”. It is exempted by **section 27.2(b)** and it is defined in **section 29**.
- 5 Three other types of charge are exempt from registration under the existing law. They are described as a “rent deposit charge”, a “Lloyd’s charge” and a “central bank charge” in the Code and are exempted from registration under the Code by **section 27.2(c), (d) and (e)**. They are defined in **section 30**.
- 6 **Section 27.2(f)** exempts from registration a charge which is exempted by other legislation. There is none at present which is not already exempted by the Code.
- 7 **Section 27.3** is not strictly necessary. It describes certain types of charge which are not “created” by a UK business, and are therefore not registrable under **section 27**. This would be the case anyway, but the purpose of the section is to confirm that transactions of the kind described do not require registration.
- 8 Consideration could be given to whether it is desirable to deal specifically with rentcharges, for instance by excluding them from the requirement for registration. This is an issue which has come up in the past.

28 Possessory charge

28.1 A charge is a possessory charge to the extent that the chargee has possession of the charged assets at the time the issue is to be determined.

28.2 A person has possession of charged assets if:

- (a) they are goods, and it has physical possession of them; or**
- (b) they are goods, and it has possession of them by attornment; or**
- (c) they are goods or intangibles, and it has documentary possession of them.**

28.3 A person (A) has possession of goods by attornment if:

- (a) someone other than the chargor or the chargee (B) has physical possession of them; and**
- (b) at the request of the chargor, B has acknowledged to A that B holds them on behalf of A.**

The acknowledgement can be in writing, but does not have to be.

28.4 A person has documentary possession of goods or intangibles if:

- (a) it has physical possession of a document of title to them (for instance, a bill of lading, a bearer security or a negotiable instrument); and**
- (b) that document is either made out to bearer or made in favour of the person concerned (whether initially or by endorsement).**

28.5 A person who has possession of charged assets does not lose that possession only because:

- (a) the assets are taken from it without its consent; or**
- (b) the assets are sub-charged by that person to someone other than the chargor with the consent of the chargor; or**
- (c) the assets are delivered to the chargor for the purpose of sale and on the basis that the net proceeds of sale are held on trust for the chargee.**

Commentary

- 1 Under the existing law, pledges are not registrable at Companies House. The purpose of **section 28** is broadly to replicate the current law but to clarify some existing uncertainties.
- 2 A pledge is a possessory security interest. Under the Code, it will be replaced by a charge which, if a “possessory charge” will not be registrable.
- 3 **Section 28.1** defines a possessory charge by reference to the chargee having possession of the charged assets. This has to be the case at the time the issue is to be determined. The reason is that it is not sufficient for the pledgee to have possession of the assets concerned at the time the pledge is created. The pledge has to continue, so that the pledgee has possession at the time the question arises.
- 4 **Section 28.2** sets out three circumstances in which a person has possession of charged assets.
- 5 The first case (**section 28.2(a)**) is where the person concerned has physical possession of goods. This is the straightforward example of a pledge and, for that reason, is rarely seen in commercial practice. It would include a case where the chargee is the sole controller of an area where the goods are situated⁵⁹.
- 6 The second case (**section 28.2(b)**) is where the person concerned has possession of goods by attornment. Attornment is described in **section 28.3**. It follows the common law concept of attornment described by Lord Wright in *Official Assignee of Madras v Mercantile Bank of India*⁶⁰.
- 7 The third type of case (section 28.2(c)) is where the person concerned has documentary possession of goods or intangibles. **Section 28.4** explains when a person has documentary possession of goods or intangibles. This is, again, intended to follow the common law approach. An important point to note about the documentary possession is that it applies not just to goods but also to intangibles which are the subject of a document of title. As a result, a possessory charge can be created by the chargee taking possession of a document of title to goods or intangibles which is either

⁵⁹ In the past, the courts have held that the creditor was in possession of the asset concerned on rather flimsy evidence. Cases include *Hilton v Tucker* (1888) LR 39 Ch D 669 and *Wrightson v McArthur and Hutchisons* [1921] 2 KB 807. It is envisaged that under the Code the Courts will be less willing to extend the meaning of “possession” in this way.

⁶⁰ [1935] AC 53 at 58-59

made out to bearer or is made in favour of the person concerned, whether initially or by endorsement.

- 8 **Section 28.5** establishes that a person who has possession of charged assets does not lose that possession only because certain things happen.
- 9 The first type of case (**section 28.5(a)**) is where the assets are taken from that person without its consent.
- 10 The second type of case (**section 28.5(b)**) is where the assets are sub-charged by the person who is in possession to someone other than the chargor with the consent of the chargor. This reflects the common law position established in *Donald v Suckling*⁶¹.
- 11 The third type of case (**section 28.5(c)**) is the most important in practice. This is where assets are delivered to the chargor for the purpose of sale and on the basis that the net proceeds of sale are held on trust for the chargee. This follows the position under the existing law⁶². **Section 28.5(c)** only allows this to be done where the assets are delivered for the purpose of sale and on the basis that the net proceeds of sale are held on trust for the chargee. That may be a narrower formulation than under the existing law. There are also certain cases under the existing law where a pledge was held to be created even though the goods were in the possession of the pledgor.⁶³ It is of the essence of a possessory charge that the asset concerned should not be in the possession of the chargor. Those cases would be decided differently under the Code.
- 12 **Section 28.5(c)** has been limited to cases where the purpose of re-delivery to the chargor is to sell the assets. That is thought to be a reasonable way of distinguishing between charges which require registration, and those which do not.

⁶¹ (1865–66) LR 1 QB 585.

⁶² See, for instance, *North Western Bank v John Poynter, Son & MacDonalds* [1895] AC 56 and *Re David Allester* [1922] 2 Ch 211.

⁶³ See, for instance, *Martin v Reid* (1862) 11 CBNS 730; and *Reeves v Capper* (1838) 5 Bing NC 136

29 Financial collateral charge

29.1 A charge is a financial collateral charge if it is created or arises under a security financial collateral arrangement.

29.2 Security financial collateral arrangement has the meaning given to it in The Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) as amended from time to time.

Commentary

- 1 The most far-reaching of the exempt charges is the financial collateral charge.
- 2 The Code does not attempt to improve upon the regulations which apply to financial collateral⁶⁴.
- 3 The scope of the regulations is unclear, particularly because of requirement that security financial collateral is in the possession or under the control of the creditor or someone acting on its behalf. What is really needed is a wholesale review of financial collateral, and the Treasury now has the power to do this by secondary legislation.
- 4 There are difficult political and commercial decisions which would have to be taken before the financial collateral rules could be reformed. We will monitor developments.

⁶⁴ The Financial Collateral Arrangement (No.2) Regulations 2003, SI 2003 / 3226, as amended.

30 Rent deposit, Lloyds and central bank charges

30.1 A rent deposit charge is a charge in favour of a landlord on a cash deposit given as security in connection with the lease of land.

30.2 A Lloyd's charge is a charge created by a member of Lloyd's (within the meaning of the Lloyd's Act 1982) to secure its obligations in connection with its underwriting business at Lloyd's.

30.3 A central bank charge is a charge which falls within section 252 of the Banking Act 2009, as amended from time to time.

Commentary

- 1 These provisions are based on the other exceptions to the registration requirement contained in the Companies Act 2006. They replicate the current law, although it is worth discussing whether they could be more clearly expressed (for instance by making specific reference to tenancy agreements in **section 30.1**).

31 Registration procedure for charges

31.1 Where a UK business has entered into a charge instrument (see part 2), the chargee, the chargor or a person acting on behalf of either of them (a registrant) may deliver to the registrar:

- (a) a certified copy of the charge instrument (or, if it is not a document, evidence of the creation of the charge); and**
- (b) a document specifying:**
 - (i) the registered name and number of the chargor;**
 - (ii) the name of the chargee;**
 - (iii) the date of creation of the charge; and**
 - (iv) whether the charge is expressed to cover all, or substantially all, of the present and future assets of the chargor.**

31.2 This can be done even if the charge concerned is an exempt charge.

31.3 The certified copy of the charge instrument can be redacted to omit:

- (a) personal information relating to an individual (other than the name of the individual);**
- (b) the number or other identifier of a bank or securities account;**
- (c) a signature.**

31.4 As soon as reasonably practicable after receipt of those documents, the registrar will register them and will deliver to the registrant an electronic confirmation that the registrar has received those documents and the time of receipt.

[It is crucial that the chargee receives confirmation of registration as soon as the documents are delivered to the registrar.]

31.5 The charge becomes registered on receipt by the registrant of that electronic confirmation.

31.6 That confirmation is conclusive evidence that the charge has been duly registered and of the time of registration.

- 31.7 The registrant may deliver to the registrar a notice of an intention to create a charge (a priority notice) in advance of the charge instrument being entered into. The priority notice must state the registered name and number of the chargor and the name of the chargee, If a charge instrument is entered into by that chargor in favour of that chargee and is registered within 30 days after the registration of the priority notice, the charge will be deemed for the purpose of priorities with third parties (see part 8) to have been registered at the time that the priority notice was registered.

Commentary

- 1 The procedure for registration of charges is contained in **section 31**. It broadly follows the approach in the regulations made under the Companies Act 2006, with certain amendments which are intended to simplify and streamline the process.
- 2 A charge may be registered by the chargee, the chargor or a person acting on behalf of either of them. In the Code, that person is known as the registrant (see **section 31.1**).
- 3 The registrant needs to deliver two documents to the registrar of companies.
- 4 The first is a certified copy of the charge instrument. This is defined in **section 7.4(b)** to be the document, words, act or other thing which creates or evidences the charge.
- 5 The second is a document specifying certain particulars. The details are set out in **section 31.1(b)**. The particulars are a simplified form of those which are currently used under the Companies Act 2006. What is required under the Code is to specify three simple factual matters (the registered name and number of the chargor, the name of the chargee and the date of creation of the charge). In addition, the registrant has to state whether the charge is expressed to cover all, or substantially all of the present and future assets of the chargor. The purpose of this last requirement is so that it should be clear from the file whether the chargee can appoint an administrator or administrative receiver of the chargor.⁶⁵
- 6 The thinking behind the Code is that the important thing for a person searching the register is to be able to read the charge instrument itself. That would be delivered under **section 31.1(a)**. It should therefore only be really key information which has to be provided under **section 31.1(b)**.

⁶⁵ Although, whether the chargee can do so depends on whether the charge satisfies the relevant criteria, not on whether the registrant says that they do.

- 7 **Section 31.2** allows exempt charges to be registered. There may be doubt about whether a charge is exempt and this section gives the parties the flexibility to register an exempt charge if they wish.
- 8 There are provisions under the Companies Act 2006 for the redaction of certain information. Those provisions are followed in **section 31.3**.
- 9 When the registrar receives the documents, it is intended that an email confirmation will be sent to confirm the receipt of those documents at a particular time. As far as possible, it is intended that this should happen automatically at any time or day or night. Because the charge is only created on registration it is crucial that the registrant receives confirmation of registration as soon as the documents are received by Companies House. See **sections 31.4 and 31.5**.
- 10 It has always been the case, since registration at Companies House was first required in 1900, that the *quid pro quo* for the invalidation of an unregistered charge should be that the chargee will know, at the time the transaction is entered into, that the charge has been properly registered, and is therefore valid. **Section 31.6** provides that the confirmation email from the registrar is conclusive evidence that the charge has been duly registered and the time of registration.
- 11 It is envisaged that there will be a facility for the registration of a priority notice, along the lines of that used at the Land Registry. **Section 31.7** makes provision for this.

32 The effect of registration

32.1 A registrable charge is created on registration.

32.2 An exempt charge does not require to be registered, but it can be registered if the parties wish to do so (for instance, because there may be uncertainty about whether the charge is exempt).

Commentary

- 1 **Section 32** explains the effect of registration. It needs to be read in the light of **section 8**, which is concerned with the time when charges are created.
- 2 If a charge is registrable (under part 7), it is only validly created on registration. This means that the charge instrument only creates personal rights until registration. Once the charge has been registered at Companies House, the proprietary rights created by the charge comes into existence. See **section 32.1 and section 8**.
- 3 An exempt charge (a charge created by UK business which does not require registration) becomes effective on creation, as does a charge which is not created by a UK business.
- 4 There may be doubt about whether registration is required, or the parties may otherwise want to register an exempt charge. For instance, a charge may be a possessory charge, but the parties may decide to register in any event because the validity of a possessory charge depends on the continued possession of the charged asset by the chargee and the chargee may not want to take that risk. Under **section 26**, whenever a UK business has created a charge, it may be registered. **Section 26.2** and **section 32.2** show that this can be done even if the charge is exempt.

33 Amendments to charges

- 33.1 If an amendment to a registrable charge extends the scope of the charged assets or of the secured obligations, it must be registered in accordance with this part 7 because, to the extent that it does so, it creates a new charge.**
- 33.2 If any other amendment is made to a charge which has been registered, the registrant may deliver a certified copy of the amendment to the registrar, who may register it. Whether or not this is done does not affect the validity of the charge or the conclusive nature of the existing certificate of registration.**

Commentary

- 1 If a charge is amended to increase the scope of the charged assets or of a secured obligations, then a new charge will be created to the extent of the increase. That requires to be registered in the normal way under **section 31.1**. See **section 33.1**. This would only apply where there was an extension of the charged assets or secured obligations. It would not apply, for instance, where a particular class of assets was charged and a subsequent document simply identified more specifically some of the assets concerned.
- 2 No other amendment to a charge requires registration. The registrant may (but does not have to) notify the registrar of an amendment and the registrar may (but does not have to) register it. Whether or not this is done does not affect the validity of the charge or the conclusive nature of the certificate of registration. See **section 33.2**.

34 Releases of charges

34.1 The registrant may send to the registrar a notice that:

- (a) the charge has been released; or**
- (b) specified assets have been released from the charge.**

34.2 If the registrar has received confirmation from the chargee (or from a person acting on behalf of the chargee) that the notice is correct, the registrar will, as soon as reasonably practicable, register it and confirm that he has done so to the registrant.

34.3 *It is sometimes impossible to get the confirmation of a chargee even where the charge has clearly been extinguished. It should be possible to tidy-up the register without confirmation from the chargee if there are appropriate safeguards.*

Commentary

- 1 Section 34** contains the mechanics for the release of charges. The charge may either be released completely (for instance, on payment in full all of the secured obligations), or specified assets may be released from the charge (for instance, because they are to be sold) but it otherwise remains in effect (**section 34.1**).
- 2** The existing rules enable the registrar to register a notice of this kind if it has been received from the chargor. **Section 34.2** alters this approach. The registrar will only register the notice once he has received confirmation from the chargee (or from the person acting on behalf of the chargee) that the notice is correct.
- 3** It is important that the chargor should not be able to amend the registration without the consent of the chargee, but this does mean that it may not be easy for chargors to tidy up their registers when charges have actually been released, but the chargee can no longer be tracked down. Consideration should be given to a mechanism which would enable the chargor to deal with this in some way – perhaps through the court.

35 Registration of receivables financing agreements

- 35.1 A receivables financing agreement is an agreement by which one person (the receivables financier) agrees to purchase receivables owing to a UK business (the customer) and the purpose, or one of the purposes, of the arrangement is to provide finance to the customer. The agreement can provide for the purchase of some or all of the customer's present and future receivables; or it can provide a framework under which receivables can be purchased in the future. Assignments of particular receivables can be effected under the agreement or by separate documents or arrangements. It includes securitisation, factoring and invoice discounting agreements.**
- 35.2 Where a receivables financing agreement has been entered into, the receivables financier, the customer, or a person acting on behalf of either of them (the registrant) may deliver to the registrar a document stating that the customer has entered into a receivables financing agreement and specifying:**
- (a) the registered name and number of the customer;**
 - (b) the name of the receivables financier;**
 - (c) the date of creation of the receivables financing agreement; and**
 - (d) the extent of the receivables which will or may be purchased under the receivables financing agreement.**
- 35.3 As soon as reasonably practicable after receipt of those documents, the registrar will register them and will deliver to the registrant a notice confirming that the receivables financing document has been registered and the time of registration.**
- 35.4 The registration of a receivables financing agreement is voluntary. The agreement does not need to be registered in order to become effective. The reason for registration is to take advantage of the priority rules for receivables financing agreements described in part 8.**

Commentary

- 1 It is been seen from section 6 that the Code applies to proprietary interests which secure the performance of a secured obligation, and that whether or not this is the case is a legal question, not an economic one.**

- 2 The Code is therefore not generally concerned with transactions which may have the same economic as secured transactions but which are created in a legally different way. So, for instance, the Code does not generally apply to:
 - (a) retention of title (ie transaction by which one person retains title to an asset, such as reservation of title clauses and leases); or
 - (b) sales of receivables.
- 3 These other types of transaction (often referred to as “quasi security”) may sometimes have a similar economic effect to the creation of security, but they do not involve the creation of security. A lease involves an owner of an asset creating a lesser interest in favour of the lessee; so that the lessee does not create any interest in favour of the lessor. And the sale of receivables creates an outright interest in favour of the buyer, not a security interest.
- 4 The procedure for the registration of charges does not, therefore, apply either to retention of title arrangements or to sales of receivables.
- 5 But there may be advantages in allowing the parties to a transaction for the sale of receivables to register that transaction for the purpose of priority. Registration would not be required to create a valid purchase but, if there were a dispute between two people who had purported to acquire interests in the receivable, the resolution of that conflict could depend on who had registered first.
- 6 An arrangement of this kind can be seen as a “voluntary” registration system, in the sense that registration is not required to create a valid proprietary interest. The purpose of registration would be to give priority against third parties – which is the same purpose as registration at the asset registries (see part 8 of the Code).
- 7 But even this type of registration is not really “voluntary” in the sense that it does not matter whether or not it is done. If there is a registration system, then failure to register will postpone the person concerned to someone else who has registered. A system of this kind should, therefore, only be established if it is considered that the priorities of dealings with receivables should primarily be catered for by the date of registration rather than by the existing priority rule in *Dearle v Hall*⁶⁶.

⁶⁶ (1828) 3 Russ 1.

- 8 The purpose of including **section 35** in the Code is to provide an opportunity to consider whether a registration system of this kind would be advantageous.
- 9 **Section 35** applies to receivables financing agreements, and they are broadly defined in **section 35.1**. Because there is no requirement to register in order to establish the validity of the agreements concerned, the definition can be drafted more expansively than would otherwise be the case.
- 10 The procedure for registration is set out in **sections 35.2 and 35.3**.
- 11 **Section 35.4** makes it clear that failure to register does not affect the validity of receivables financing agreement, but only affects its priority against other encumbrancers.
- 12 We would welcome comments on whether a “voluntary” registration of this kind would be useful

PART 8: PRIORITIES

General commentary

- 1 The priority rules under the existing law are extremely complicated. Where there is a priority dispute between two people who have proprietary interests in a debtor's assets, the result may depend on the dates on which the respective interests were created⁶⁷, or on the dates on which they were registered in an asset registry⁶⁸, or on the date on which a third party received notice of the interests concerned⁶⁹. The date of registration at Companies House can have a bearing⁷⁰, as can the conduct of the parties⁷¹. The outcome can also depend on the nature of the asset (whether it is land, goods or intangibles⁷²) or on the nature of the claimant's interest in the asset (whether it is legal or equitable⁷³ and, if equitable, whether it is fixed or floating⁷⁴). There are many possible permutations.

- 2 But, in spite of that, there have been very few priority disputes between secured creditors or between a secured creditor and a person claiming an outright interest in the last century. There are two main reasons for this. The first is that priority disputes generally arise where a person has fraudulently created two interests over the same asset and, thankfully, that is not an everyday occurrence. And the second reason is that the requirement for the registration of most corporate charges at Companies House has meant that the chance of a company being able to perpetrate such a fraud is much less likely.

⁶⁷ At common law, this is the result of the maxim *nemo dat quod non habet*. In equity, see *Phillips v Phillips* (1861) 4 De GF & J 208 at 215 (Lord Westbury LC),

⁶⁸ This is the rule for land, ships, aircraft and certain types of intellectual property. For example, see Land Registration Act 2002, ss 28-30 and 48, and Sch 3,

⁶⁹ In the case of contract rights and equitable interests, under the rule in *Dearle v Hall* (1828) 3 Russ 1.

⁷⁰ It can provide constructive notice and therefore override the *bona fide* purchaser rule and the rule in *Dearle v Hall* and it can also affect priorities between fixed and floating charges.

⁷¹ If, as a result, the equities are not equal. See *Rice v Rice* (1853) 2 Drew 73.

⁷² Which priority rules apply often depends on the type of asset charged.

⁷³ The *bona fide* purchaser rule can give a legal mortgagee or pledgee of goods priority over an earlier equitable charge. See *Joseph Lyons* (1884) 15 QBD 280. And, in some cases, it is still possible to tack *tabula in naufragio*. See *Macmillan v Bishopsgate Investment Trust (No 3)* [1995] 1 WLR 978 at 999-1005.

⁷⁴ The rules applied to the priority of a floating charge are different from those for a fixed charge. See *Wheatley v Silkstone and Haigh Moor Coal Co* (1885) 29 ChD 715.

- 3 There is nevertheless much sense in attempting to simplify the priority rules, and this is what the Code tries to do. But, because the Code only deals with security interests, and not generally with outright transactions, it is not able completely to rewrite the priority rules. It cannot, for instance, abolish the distinction between legal and equitable interests for the purpose of priorities because they may continue to be relevant where an outright interest is involved to which the Code does not apply. But what the Code can do is to simplify the priority rules between chargees.
- 4 Priority issues are not confined to disputes between chargees. They can also arise between a chargee and a purchaser. The Code therefore also deals with the circumstances in which a purchaser can (and cannot) take priority over an existing charge.⁷⁵

⁷⁵ In the PPSA jurisdictions, this is described as “taking free”.

36 The scope of this part

36.1 This part deals with the following priority issues:

- (a) priorities between charges;**
- (b) priorities between receivables financing agreements;**
- (c) priorities between a charge and a receivables financing agreement;**
- (d) priorities between a charge and a subsequent transaction for which no value is given;**
- (e) the ability of a chargor to tack further advances; and**
- (f) priorities between a charge and a subsequent outright disposition of assets subject to the charge.**

36.2 All these priority issues are determined in accordance with this Code, which overrides any priority rule which would otherwise have applied under the general law.

36.3 All other priority issues are determined under the general law. In a priority dispute between a charge and another proprietary interest which is not determined under this Code, it may therefore depend on whether the charge concerned is a legal charge or an equitable charge.

Commentary

- 1 Section 36.1** explains the scope of part 8.
- 2** Where the Code applies, priority issues are determined in accordance with the Code, and not with the general law (**section 36.2**). But all other priority issues are determined under the general law (**section 36.3**).

37 Priorities between charges

37.1 The priority of charges between themselves is determined by the following rules, which are to be applied in the following order.

37.2 Rule 1: Where a chargor has created more than one charge over the same charged asset, the priority of the charges can be agreed by the chargor and the chargees concerned. Subject to the requirements of any relevant asset registry, that agreement can be made at any time and without formality.

37.3 Rule 2: If a chargee takes a charge over an asset when it actually knows that it is already charged, the new charge will rank behind the earlier charge unless the persons concerned have agreed to the contrary or the asset is registrable in an asset registry and the rules of the asset registry provide to the contrary.

37.4 Rule 3: To the extent that the charged assets consist of assets which are registrable in an asset registry and the parties have not agreed their priority in the manner required by the asset registry concerned, priority between charges depends on the rules of the relevant asset registry.

37.5 Rule 4:

It may be necessary to have special priority rules for security over financial collateral.

In relation to cash and financial instruments, this may involve two rules:

- *The basic rule would be that priority depends on the times when the chargees concerned obtained possession or control of the charged assets concerned: the first to take possession or control has priority. (In this context, “possession” and “control” would have the particular meanings given to them in the financial collateral legislation.)*
- *But this would be subject to the second rule: If the first chargee to take possession or control has an equitable charge, and the second chargee to do so has a legal charge, the second chargee will take priority over the first charge unless, at the time it took possession or control, the second chargee had actual (or possibly constructive) notice of the first charge.*

In relation to credit claims, it may be necessary to continue to use the rule in Dearle v Hall.

- 37.6 Rule 5: In any other case, the priority of charges between themselves depends on the times they are created. As between two charges, the first to be created has priority. For this purpose, where there is a priority notice the date of creation means the date of registration of the priority notice.
- 37.7 When applying these rules to a charge, it makes no difference that the chargee has authorised the chargor to dispose of charged assets free of the charge, unless the parties have agreed to the contrary.
- 37.8 The asset registries are:
- (a) Her Majesty's Land Registry;
 - (b) the register of British ships;
 - (c) the register of aircraft mortgages maintained by the Civil Aviation Authority;
 - (d) the registers of patents and of trade marks maintained by the Comptroller-General of Patents, Designs and Trade Marks.

[Other registries may need to be added, for instance international registries.]

Commentary

- 1 Priority rules are normally seen as rules of law which can, sometimes, be varied by agreement between the parties. The approach of the Code is different. In the Code, the very first rule establishes party autonomy. If the parties (ie the chargor and the chargees concerned) have agreed the priority of their charges, then that is the end of the matter. Except to the extent that any asset registry requires particular formalities, the agreement can be made at any time and without formality. That is the effect of **Rule 1** contained in **section 37.2**.
- 2 The starting point is therefore to establish what the parties have agreed. It is only if the relevant parties have not reached an agreement, that we need to look any further.
- 3 The next rule concerns notice. Under **Rule 2** (which is contained in **section 37.3**), the basic rule is that if a chargee takes a charge over an asset when it actually knows that

it is already charged, the new charge will rank behind the earlier charge. This rule gives effect to what would seem to be a clear moral imperative. If I take security over an asset when I know that you already have security, I should not be able to leap frog you⁷⁶. The parties can agree to the contrary (this is expressly provided for **section 37.3**).

- 4 There is an exception to this rule where the assets are registrable in an asset registry and the rules of the asset registry provide to the contrary. The asset registries are described in **section 37.8**. They extend to land, ships, aircraft, patents and trademarks. The purpose of those registers is to establish with (a fair degree of) certainty the ownership of registered assets and the priority of encumbrances over them. In many cases, priority is established by reference to the date of registration, even if the first to be registered was aware of an earlier encumbrance which was registered later. The Code does not purport to override the priority rules set out in the asset registries. It is therefore an exception to **Rule 2** that it will not apply if it would contravene the rules of an asset registry.
- 5 **Rule 3** (which is contained in **section 37.4**) applies where the asset concerned is registrable in an asset registry. It gives effect to the priority rules which are determined by the legislation under which the asset registries are created. So, where there is a question as to the priority of two charges over registered land, it is the Land Registration Act and Rules which will determine that matter. Generally speaking, the asset registries determine the priority of charges by reference to the date of registration in the asset registry concerned.
- 6 **Rule 4** (which is contained in **section 37.5**) is concerned with financial collateral. It may be necessary to have special priority rules for security over financial collateral. The precise nature of those rules has yet to be determined.
- 7 **Rule 5** is contained in **section 37.6**. If none of the other Rules apply, the priority of charges between themselves depends on the times they are created. A registrable charge is not created until it is registered (see **section 8**). If there is a priority notice, for the purpose of priorities the charge is deemed to have been created at the time the priority notice was registered.

⁷⁶ This requires actual notice. Constructive notice is insufficient.

- 8 Under the existing law, the priority rules for floating charges are different from those for fixed charges.⁷⁷ The Code does not distinguish between fixed and floating charges and it does not treat the priority of a floating charge any differently from the priority of a fixed charge. This is provided for in **section 37.7**.

⁷⁷ See, for instance, *Re Castell & Brown* [1898] 1 Ch 315 and *The English and Scottish Mercantile Investment Company v Brunton* [1892] 2 QB 700.

38 The priority of receivables financing agreements

38.1 Where:

- (a) more than one receivables financing agreement; or
- (b) one or more receivables financing agreements and one or more charges

have been created over the same receivables, the priority between them is determined by the following rules, which are to be applied in the following order.

38.2 In this section:

- (a) a financing is a receivables financing agreement or a charge; and
- (b) a financier is a chargee taking a charge or a receivables financier entering into a receivables financing agreement.

38.3 Rule 6: The priority of financings between themselves can be agreed between the parties concerned. That agreement can be made at any time and without formality.

38.4 Rule 7: If a financing is created when the financier actually knows the receivables are already subject to an existing financing, the new financing will rank behind the earlier one unless the parties have agreed to the contrary.

38.5 Rule 8: In any other case, the priority of the financings between themselves depends on:

- (a) in the case of a charge, the time it is created; and
- (b) in the case of a receivables financing agreement, the time it is registered in accordance with part 7.

The first to be created (in the case of a charge) or registered (in the case of a receivables financing agreement) has priority.

Commentary

- 1 Because **section 35** provides for the voluntary registration of receivables financing agreements, it is necessary to set out the priority of agreements of that type, and this is done in **section 38**.

- 2 **Section 38** follows the approach of **section 37** except where it is not applicable. So, because there are not asset registries for receivables, **Rule 3** is not replicated in **section 38**.
- 3 **Rule 6** is the equivalent of **Rule 1**, **Rule 7** is the equivalent of **Rule 2** and **Rule 8** is the equivalent of **Rule 5**.

39 Transactions for which no value is given

- 39.1 If a person purports to obtain a proprietary interest in a charged asset from a chargor for no consideration (for instance as a gift), that person takes its proprietary interest subject to the charge.**
- 39.2 If a person obtains execution of any kind over a charged asset, the execution is subject to the charge.**

Commentary

- 1 **Section 39** is concerned with transactions for no consideration. This includes gifts, but also commercial transactions for which there is no consideration, such as the levying of execution.
- 2 It is one thing for a person who gives value to take priority over an earlier charge, but a person who has not given value should be in no better position than the chargor. A donee should take subject to any proprietary interests over the asset concerned. And the same to true of an execution creditor⁷⁸.

⁷⁸ See *United Bank of Kuwait v Sahib* [1997] Ch 107 at 119.

40 Tacking further advances

- 40.1 When a charge has priority over any other proprietary interest (whether outright or by way of security) that priority extends to the entire secured obligation secured by the charge, regardless of the time advances were made.
- 40.2 This is the case unless the parties have agreed to the contrary.
- 40.3 All restrictions on tacking further advances are abolished.

Commentary

- 1 **Section 37** contains the rules which provide for priorities between charges. The extent to which a charge has priority depends on the scope of the charged assets and the identity of the secured obligation. If A and B both have a charge over a particular asset, and A's charge takes priority over B's charge, it follows that A's charge ranks ahead of B's charge to the extent of the obligations which are secured under A's charge. A has priority over B to the extent of the secured obligations, but not further. So if A has lent 100 to the chargor, but only 60 is secured, then A will rank in priority to B for 60, but not for the remaining 40.
- 2 That gives effect to the basic principle behind the Code that a charge is a matter of intention, and that the scope of the charged assets and of the secured obligations depend on the objective intention of the chargor (see **section 18.3**).
- 3 Under the existing law, the rules concerning tacking further advances restrict the priority of A over B. The rules are different depending on whether the charged asset is registered land, unregistered land or other assets. But, in all cases, the rules restrict A's ability to apply the charged assets in discharge of the secured obligations.
- 4 This was not always the case. In the eighteenth century, the law recognised that, if A had priority over B, then that priority extended to the totality of the secured obligations⁷⁹ but, in *Hopkinson v Rolt* in 1861⁸⁰, the House of Lords decided to limit A's priority. Once A had received notice of B's charge, then it was no longer able to take priority for any further advances.

⁷⁹ *Gordon v Graham* (1716) 2 Eq Cas Abr 598.

⁸⁰ (1861) 9 HLC 514.

- 5 The particular rules concerned depend on the nature of the asset – whether they are registered land⁸¹, unregistered land⁸² or other assets⁸³. But, whatever the nature of the asset, the effect of the rules is to prevent A from having the priority for the secured obligations which were agreed between it and the chargor when the charge was executed.
- 6 The Code abolishes all these restrictions on tacking further advances (**section 40.3**). Under the Code, therefore, the extent of the obligations which are secured in priority to a subsequent charge depend on the interpretation of the terms of the first charge (**section 40.1**).
- 7 As usual, the parties are free to agree to contrary (**section 40.2**).

⁸¹ Land Registration Act 2002, s49 and Land Registration Rules 2003 r 107.

⁸² Law of Property Act 1925, s 94.

⁸³ *West v Williams* [1899] 1 Ch 132.

41 Outright dispositions of assets

41.1 If a person other than a receivables financier (the acquirer) purports to acquire an outright proprietary interest in a charged asset by contract from a chargor which is not in insolvency proceedings (see part 10), the acquirer will obtain its interest in the asset free from the charge if:

- (a) the chargor had the actual or apparent authority from the chargee to effect the transaction; or**
- (b) in the case of a current asset, the following section applies; or**
- (c) in the case of a fixed asset, the next section but one applies.**

41.2 A charged asset is a current asset if:

- (a) the chargor carries on a business; and**
- (b) a reasonable person in the position of the acquirer would regard the asset as a current asset of that business under generally accepted accounting principles in the United Kingdom at the time the charge is created.**

41.3 A charged asset is a fixed asset if it is not a current asset.

42 Outright dispositions of current assets

42.1 If a person other than a receivables financier (the acquirer) purports to acquire an outright proprietary interest in a current asset by contract from a chargor which is not in insolvency proceedings (see part 10), the acquirer will obtain its interest free from the charge unless:

- (a) the acquisition is prohibited in a contract entered into between the chargor and the chargee (a restriction on disposal); and**
- (b) the acquirer actually knew of the restriction on disposal at the time of the purported acquisition.**

42.2 Nothing in this section absolves the chargor from the consequences of any breach of contract which it commits as a result of breaching a restriction on disposal.

42.3 In the absence of fraud (in the sense of dishonesty), the acquirer is not liable to any person for any breach of a restriction on disposal of a current asset by the chargor (whether in tort, in equity or in any other manner).

43 Outright dispositions of fixed assets

43.1 If a person other than a receivables financier (the acquirer) purports to acquire an outright proprietary interest in a fixed asset by contract from a chargor which is not in insolvency proceedings (see part 10), the acquirer will obtain its interest free from the charge unless, at the time of the purported acquisition:

- (a) the acquirer actually knew the asset was subject to a charge; or
- (b) the charge was on the register at Companies House or at an asset registry;
or
- (c) the acquirer had constructive notice that the asset was subject to a charge.

43.2 A person will only have constructive notice that an asset is subject to a charge if that person would have discovered the existence of the charge if it had made all those enquiries which it ought reasonably to have made before entering into the transaction concerned. What is reasonable depends on all the circumstances relating to the transaction (for instance, the identity of the parties, the nature of the assets concerned and the size of the transaction).

Commentary

1 **Sections 41 to 43** are concerned with outright dispositions of assets. In what circumstances will a person who buys an asset which is subject to a charge take free from the charge?

2 English law has generally applied the same priority rules to purchasers as it applies to subsequent secured creditors. It does not generally matter whether the person who is trying to take priority over a charge has obtained an outright interest or a security interest. So, for instance, the *bona fide* purchaser rule applies as much to a mortgagee or a pledgee as it does a purchaser⁸⁴. The rule in *Dearle v Hall*⁸⁵ applies to all dealings in receivables, whether they are outright or by way of security. And the priority rules of

⁸⁴ *Joseph v Lyons* (1884) 15 QBD 280.

⁸⁵ (1828) 3 Russ 1.

the asset registries generally distinguish between registered and unregistered interests, not between security interests and outright interests.⁸⁶

- 3 In practice, the main exception concerns constructive notice. Constructive notice is of little relevance to transactions which are registered at an asset registry⁸⁷ but, in it does still have an important part to play in security taken over assets which are not the subject of asset registries, which includes most types of goods (except ships and aircraft) and most types of intangible assets (other than intellectual property). The starting point for a priority issue in relation to these types of asset is that the first to be created take priority over a later interest.⁸⁸ But there are a large number of exceptions to that basic principle.
- 4 One exception is the *bona fide* purchaser rule, by which a *bona fide* purchaser of the legal title to an asset for value and without notice of a prior equitable interest will take free of that interest.⁸⁹ There is also the rule in *Dearle v Hall*⁹⁰ which establishes that, in relation to receivables, the relevant date for priority is not the date of creation but the date on which notice is given to the person who owes the receivable.
- 5 In theory, therefore, both rules override the rule that the first interest to be created takes priority. But in practice, the most important point about both of these rules is that neither give priority to a subsequent encumbrancer if that person knew or ought to have known of the existence of the earlier interest at the time the subsequent interest was acquired⁹¹.
- 6 In both cases, it is not just actual notice which prevents the subsequent encumbrancer from taking priority. Constructive notice is sufficient. The practical importance of this is that most security created by companies is registrable, and the question is therefore whether registration at Companies House constitutes constructive notice.

⁸⁶ See, for instance, the Land Registration Act 2002, ss 28-30 and 48 and Sch 3.

⁸⁷ Although it is relevant to mortgages over patents and patent applications. See Patents Act 1977, s33.

⁸⁸ This is the foundation of the principle *nemo dat quod non habet* at common law, and it is also relevant in equity: *Phillips v Phillips* (1861) 4 De GF & J 208 at 215.

⁸⁹ *Pilcher v Rawlins* (1872) LR 7 Ch App 259.

⁹⁰ (1828) 3 Russ 1.

⁹¹ In relation to the *bona fide* purchaser rule, see, for instance the comments of Lord Browne – Wilkinson in *Barclays Bank v O'Brien* [1994] 1 AC 180 at 195-196 and *Macmillan v Bishopsgate Investment Trust* (No.3) [1995] 1 WLR 978. In relation to the rule in *Dearle v Hall*, see *Spencer v Clarke* (1878) 9 Ch D 137.

- 7 There is little authority on this point but in principle the question is whether the person who acquired the subsequent interest ought to have searched the register. This is a question of fact depending on what a reasonable person ought to have done in similar circumstances⁹². This requires an analysis of the whole transaction – the nature of the asset, the type of the transactions, the amount involved, the parties concerned. The principle is described in **section 43.2**.
- 8 A chargee would normally be expected to search the register. The same is true of a factor, even though the factor is acquiring an outright interest in the asset concerned. But a normal purchaser may well be in a different position, particularly if the transaction is for a relatively small consideration.
- 9 The one area where the existing law does take a different approach between chargees and outright purchasers is therefore in relation to constructive notice.
- 10 The Code takes this further. It draws a clear distinction between, on the one hand, priority disputes between chargees or between chargees and receivable financiers, and, on the other hand, priorities between chargees and subsequent purchasers.
- 11 The rules for priority between charges are contained in **section 37**; and the priority of receivables financing agreements is provided for in **section 38**. Outright purchases of assets are the subject of **sections 41 to 43**.
- 12 **Section 41.1** sets out the circumstances in which a purchaser will take free of an existing charge.
- 13 It applies where a person purports to acquire an outright proprietary interest in a charged asset by contract. It does not apply where the person concerned is a receivables financier, because the priority of receivables financing agreements are determined by **section 38**. Nor does it apply where the chargor is in insolvency proceedings. The efficacy of the transaction in such a case would depend on insolvency law.
- 14 If **section 41.1** does apply, it sets out three circumstances in which the acquirer takes free of the charge. The first (under **section 41.1(a)**) is where the chargor has the actual or apparent authority of the chargee to effect the transaction. This gives effect to the normal rules of agency law. The chargor may have the actual authority from the chargee to sell the asset concerned. This would be the case, under the existing law, in

⁹² *Bailey v Barnes* [1894] 1 Ch 25 at 34-35.

many floating charges. But even if the chargor does not have actual authority, it might have apparent (or as it is sometimes known, ostensible) authority to dispose of the asset. This would be the case if, under the principles of agency law, the chargee has held out the chargor as having the authority concerned. Under the existing law, apparent authority is important in relation to floating charges⁹³, and it can also be relevant in other types of case⁹⁴.

- 15 The other two circumstances in which a person will take free of a charge under **section 41.1** depends on whether the asset over which the charge has been created is a current asset or a fixed asset. A current asset is defined in **section 41.2**, and a fixed asset in **section 41.3**.
- 16 Why has the Code drawn this distinction between fixed and current assets?
- 17 The starting point is that the powers of the chargor to dispose of the charged assets is something which should be dealt with in the charge instrument itself. If the chargee has given the chargor the authority to dispose of the asset free from the charge then, of course, the purchaser will take free from the charge. And what is true of actual authority, must also be true of apparent authority. That is the effect of **section 41.1(a)**.
- 18 But that cannot be the only circumstance in which a purchaser can take free from the charge. There are likely to be cases where the charge is drafted in such a way that it restricts the chargor's ability to dispose of assets which it would be expected to have the authority to dispose of. If the chargor disposes of asset in breach of a restriction, then it is liable for the consequences. But it does not necessarily follow that the purported purchaser should lose the asset. What if the asset is of a kind which the purchaser would expect the chargor to be able to dispose of, and it is not appropriate for the purchaser to carry out an investigation.
- 19 Under the current law, this issue is dealt with by distinguishing between types of charge. Where the charge is a fixed charge, the purchaser will only take free of the fixed charge if it can rely on one of the priority rules which overrides the first in time rule. But where the charge is a floating charge, the purchaser will obtain the asset

⁹³ *Re Castell & Brown* [1898] 1 Ch 315 and *The English and Scottish Mercantile Investment Company v Brunton* [1892] 2 QB 700.

⁹⁴ See, for instance, *Perry Herrick v. Attwood* (1857) 2 De G & J 21; *Brocklesby v Temperance Permanent Building Society* [1895] AC 173 and *Rimmer v Webster* [1902] 2 Ch 163.

concerned free from the floating charge unless it had (actual or constructive) notice of a restriction in the charge.

- 20 The problem with this approach is that a person dealing with the chargor may not necessarily be able to establish very easily whether the charge is fixed or floating⁹⁵. The one thing which the purchaser does know is the nature of the asset concerned. Rather than drawing a distinction between types of charge, the Code therefore draws a distinction between types of asset.
- 21 If the asset is of a kind which the seller would normally be expected to dispose of in the ordinary course of its business, then it should be easier for the purchaser to take free than where it is acquiring an asset which would not normally be disposed of in the ordinary course of business.
- 22 The Code has therefore adopted an accounting approach to this exercise. A charged asset is a current asset if the chargor carries on a business and the asset would be regarded as a current asset of that business under UK GAAP at the time the charge is created (see **section 41.2**). If a charge is not a current asset, then it is a fixed asset (see **section 41.3**).
- 23 The problem with this test is that it is inherently uncertain. The alternative would be to be more specific about the types of asset which are fixed assets and those which are current assets. But the problem with this approach is that the very nature of current assets is that they are disposed of in the ordinary course of business of the company concerned. Whether that is the case depends, to some extent, on the nature of the asset but it also depends on the nature of the seller's business. It would be possible to define more closely what is meant by current assets and fixed assets but this would produce an outcome which may not necessarily reflect what the parties' legitimate expectations would have been.
- 24 There is no absolutely right answer to the question. The approach taken by the Code is to adopt the accounting definitions because they most clearly reflect the likely expectations of the parties. That may produce uncertainty in some cases because, although the test is clear, its application to the particular facts is not necessarily clear. But issues of this kind do not occur frequently in practice, and it was considered better to base the outcome on the reasonable expectation of the parties.

⁹⁵ It is notoriously difficult to distinguish between fixed and floating charges in practice.

- 25 Whether or not an asset is a current asset is a matter of accounting practice, but it needs to be considered from the position of a reasonable person in the position of the acquirer. The question is not necessarily whether the asset is a current asset in the accounts of the chargor. What is important is how a reasonable person in the position of the acquirer would regard the asset, based on what such a person would know about the business of the chargor. This is established in **section 41.2**.
- 26 **Section 42** is concerned with outright dispositions of current assets. The principle in **section 42.1** is that the acquirer will only take its interest subject to the charge if there is a restriction on disposal in the charge instrument or in a related document and the acquirer actually knew of that restriction at the time of the purported acquisition.
- 27 The important point here is that, where the asset is a current asset, the acquirer will only be bound by a restriction if it had actual notice of the restriction at the time of the purported acquisition. Constructive notice is irrelevant. The only thing that matters is whether the acquirer actually knew of the restriction at the relevant time.
- 28 There may be concern that this approach is too protective of the purchaser, and we would welcome discussion of the point.
- 29 The purpose of **section 42.3** is to prevent the acquirer being liable in any other way as a result of the acquisition – for instance in tort. In the absence of fraud (in its common law sense of dishonesty) the acquirer is not otherwise liable for having acquired the asset.
- 30 If the chargor acts in breach of the restriction, it will be liable to the chargee for breach of contract, and this is made clear by **section 42.2**. If the chargee knew that the chargor was intending to sell an asset in breach of a restriction, it may be able to obtain an injunction to prevent the sale. Nothing in **section 42** alters the circumstances in which such an injunction would be available.
- 31 **Section 43** is concerned with the outright disposal of a fixed asset.
- 32 Here, the odds are stacked more heavily against the acquirer. In the case of a fixed asset, the acquirer should do more to satisfy itself that there is no charge. Clearly, if the acquirer actually knew the asset was subject to a charge, then it should be subject to it (**section 43.1(a)**). But it will also take subject to the charge if the charge was registered at Companies House or at an asset registry (**section 43.1(b)**) or if the

acquirer had constructive notice that the asset was subject to a charge (**section 43.1(c)**).

33 **Section 43.2** contains a definition of constructive notice which is based on the existing law.

34 The essence of **section 41** is that, if a person is acquiring a fixed asset, then it ought to carry out the necessary searches.

PART 9: ENFORCEMENT

44 The scope of this part

- 44.1 This part applies to the enforcement of charges, except to the extent that other laws (for example those concerning financial collateral, financial markets or settlement finality) provide to the contrary.**
- 44.2 Where the chargor is a natural person, this part is subject to all laws concerning consumers.**

Commentary

- 1 Part 9 concerns the enforcement of charges. It applies generally to the enforcement of all charges, but it is subject to other specific legislation (**section 44**).
- 2 For instance, there are specific provisions concerning enforcement in the Financial Collateral Arrangements (No.2) Regulations 2003. And, of course, where the chargor is a consumer, any relevant restrictions contained in the consumer credit legislation will apply.

45 Time for enforcement

- 45.1 A chargee can enforce a charge at the time provided for it in the charge instrument, or as otherwise agreed by the chargor.**
- 45.2 If there is no such provision or agreement, the chargee can enforce the charge as soon as:**
- (a) all or any part of the secured obligation is payable; and**
 - (b) the person liable to pay the secured obligation has received notice requiring it to be paid; and**
 - (c) unless the chargor is insolvent or admits it is unable to pay the secured obligation in full, two business days have elapsed from the receipt of that notice, and the amount payable has not been paid in full.**

Commentary

- 1 **Section 45** is concerned with the time for enforcement of a charge.
- 2 A charge will almost invariably provide for when it can be enforced, and **section 45.1** gives effect to what the parties have agreed. This agreement will normally be contained the charge instrument itself, but it may be contained elsewhere, or it may be supplemented or amended by agreement between the parties. **Section 45.1** gives effect to that agreement wherever it is contained.
- 3 It would be surprising to find a charge without enforcement provisions. But **section 45.2** sets out default rules in the event that the charge does not do so. This section only applies if the parties have not otherwise agreed when the security should be enforceable.
- 4 The default power applies once the person who is required to pay the secured obligations (it may not be the chargor) has received a demand for money which is payable. If the chargor is insolvent or it admits that it is unable to pay the secured obligations in full, the security can be enforced immediately. If not, the chargee must wait two business days to see whether the amount is paid. If it has not been paid in full at the end of two business days, then the chargee may enforce the charge from the beginning of the third business day.

- 5 The notice period under **section 45.2** is much shorter than that contained in section 103 of the Law of Property Act 1925, but that provision is invariably contracted out of.
- 6 Where the chargee relies on an express power of enforcement, the time for enforcement depends on the interpretation of the charge document (or if elsewhere, the other agreement reached between the parties). The Code is not intended to alter the conclusion in cases such as *Massey v Sladen*⁹⁶ that, even if the words require immediate payment, the parties are likely to have intended the debtor to have sufficient time to effect the payment. But this only gives the debtor sufficient time to enable it to pay the money from a source already available to it (for instance a bank account in credit), and even that is unnecessary if the debtor clearly cannot pay⁹⁷.

⁹⁶ (1868) LR 4 Exch 13.

⁹⁷ *Cripps v Wickenden* [1973] 1 WLR 944; *Bank of Baroda v Panessar* [1987] Ch 335.

46 Enforcement powers

- 46.1 A chargee can enforce a charge in the manner provided for in the charge instrument, or as otherwise agreed by the chargor.**
- 46.2 A chargee has the following default powers:**
- (a) to the extent permitted by the insolvency legislation (see part 10), to appoint an administrator or administrative receiver of the chargor;**
 - (b) to appoint a receiver over all or any part of the charged assets;**
 - (c) to take all such other actions (or to refrain from doing so) in relation to all or any part of the charged assets as the chargor could have done if they were not charged (for instance by taking possession of them, selling them or leasing them; exercising a power of netting; in the case of receivables, demanding and receiving payment; and, in the case of cross-claims, setting them off).**
- 46.3 The default powers do not apply to the extent that they are inconsistent with the terms of the charge or the agreement of the parties. They can be increased, reduced, disapplied or amended in any other way in the charge or by agreement between the parties.**
- 46.4 For the purpose of enforcing a charge, the chargee can:**
- (a) transfer or procure the transfer of the legal title to a charged asset even if it only has an equitable charge over it; and**
 - (b) execute a deed even if the charge instrument concerned is not a deed.**
- 46.5 To the extent that the charge is a financial collateral charge (see part 7), the chargee also has the powers (for instance, the power of appropriation) conferred on it by the Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) as amended from time to time.**
- 46.6 The power to take possession of a dwelling-house is subject to the restrictions contained in section 36 of the Administration of Justice Act 1970, as amended by section 8 of the Administration of Justice Act 1973.**
- 46.7 Foreclosure is abolished.**

Commentary

- 1 The Code enables the parties to determine what the powers of enforcement should be. This can be done in the charge instrument itself or elsewhere (see **section 46.1**).
- 2 This continues the existing principle under the current law that the parties are free to decide what the powers of enforcement should be. The parties to a charge almost invariably take up this offer, and it is almost unheard of to see a charge which does not contain enforcement powers. This is partly because the parties can then shape the powers of enforcement to the particular transaction concerned. It is also because the underlying default powers of enforcement under the existing law are inadequate.
- 3 It is envisaged that the current practice of setting out the powers of enforcement in the charge will continue. But the Code also takes the opportunity to update the default powers of enforcement. They are set out in **section 46.2**.
- 4 Where the charge consists of a debenture, the normal practice is to appoint an administrator to enforce the security. The power to do this is contained in the insolvency legislation. The Code also gives the chargee the power to appoint an administrative receiver where this is permitted under section 74A-H of the Insolvency Act 1986. See **section 46.2(a)**.
- 5 Under **section 46.2(b)** the chargee can appoint a receiver over charged assets.
- 6 The Code does away with all the very specific powers - and their limitations – contained in the general law as it is at the present. The problem with the current default powers of enforcement is that they are both complicated and incomplete, and do not reflect current practice.
- 7 Under **section 46.2(c)**, the chargee is given the power to do anything with the charged assets which the chargor could have done if they were not charged. The approach of the Code, here, is to give the chargee a general power rather than to set out a long list of specific powers. The intention is to give the chargee the ability to do anything with the assets which the chargor could have done. It is intended that this should be given a broad interpretation.
- 8 The default powers only apply to the extent that they are consistent with the parties' agreement (**section 46.3**).

- 9 The purpose of **section 46.4** is to deal with two technical issues. An equitable charge will need to transfer the legal title to the charged asset on enforcement even though it only has an equitable charge. **Section 46.4(a)** enables it to do so.
- 10 Similarly, **section 46.5(b)** gives a chargee power to execute a deed even if the charge instrument is not a deed.
- 11 The powers of enforcement contained in the Code can be increased by other legislation (see **section 44.1**). Where the charge concerned is a financial collateral charge, the chargee therefore also has the powers conferred on it by the Financial Collateral Arrangements (No.2) Regulations 2003 (**section 46.5**). This includes the power of appropriation and the right of use.
- 12 In the same way as other legislation can increase powers of enforcement, it may also reduce them. The power to take possession of a dwelling house is subject to restrictions contained in section 36 of the administration of Justice Act 1970, as amended by section 8 of the Administration of Justice Act 1873. The Code does not affect these restrictions (**section 46.6**).
- 13 Foreclosure is abolished by **section 46.7**. Because it is such a complicated legal process, it is not used in practice.

47 Powers of administrators and receivers

- 47.1 An administrator has the powers conferred on him or her by the insolvency legislation.**
- 47.2 An administrative receiver and a receiver each have the powers conferred on them in the charge or by agreement with the chargor.**
- 47.3 Except to the extent that they are amended in the charge instrument or by agreement with the chargor:**
- (a) an administrative receiver and a receiver each have the power to take all such actions (or refrain from doing so) in relation to all or any part of the charged assets over which they are appointed as the chargor could have done if they were not charged (for instance by taking possession of them, selling them or leasing them; exercising a power of netting; in the case of receivables, demanding and receiving payment; and, in the case of cross-claims, setting them off); and**
 - (b) (without limitation) an administrative receiver has the powers conferred on him or her by the insolvency legislation (see part 10).**
- 47.4 An administrator, an administrative receiver and a receiver can:**
- (a) transfer legal title to a charged asset even if he or she is only appointed under an equitable charge; and**
 - (b) execute a deed even if the charge instrument concerned is not a deed.**
- 47.5 The power to take possession of a dwelling house is subject to the restrictions contained in section 36 of the Administration of Justice Act 1970, as amended by section 8 of the Administration of Justice Act 1973.**

Commentary

- 1 Section 47** deals with the specific powers of administrators and receivers. It follows the approach of **section 46**.
- 2** Administrators' powers are conferred by the insolvency legislation (**section 47.1**).

- 3 On the other hand, the powers of an administrative receiver or a receiver are conferred by the charge or by agreement with the chargor (**section 47.2**).
- 4 **Section 47.3** then goes on to deal with default powers of administrative receivers and receivers. An administrative receiver has the powers conferred by Schedule 1 to the Insolvency Act 1986. Administrative receivers and receivers each have the powers of the chargor in relation to the assets over which they are appointed. This is intended to be a broad power.
- 5 The other provisions of **section 47** replicate those in **section 46**.

48 More than one charge

- 48.1 Where there is more than one charge over the same charged asset, the charged asset can be sold free from any charges which rank behind the charge concerned. If this happens, the rights of the subsequent chargees are transferred from the charged asset to its proceeds of sale.**
- 48.2 48.2 Where there is more than one charge over the same charged asset, the charged asset can be sold under a second or subsequent charge subject to any charges which rank in priority.**
- 48.3 This section is subject to any agreement to the contrary between the relevant parties.**

Commentary

- 1 Under **section 48.1**, a first chargee (or someone on its behalf) is able to sell the charged assets free from any second or subsequent charge. Similarly, a second chargee (or someone on its behalf) can sell subject to a third or subsequent charges. The rights of the subsequent chargees are overreached into the proceeds of sale.
- 2 A chargee cannot overreach prior charges. So, if a second chargee (or someone on its behalf) sells, it can only do so subject to the first charge (**section 48.2**). In many cases, this will make it very difficult to sell the asset concerned without the agreement of the first chargee.
- 3 The parties will frequently agree their respective powers in an intercreditor agreement. **Section 48.3** establishes that **section 48** is subject to any contrary agreement between the parties.

49 Effect on third parties

- 49.1 An administrative receiver of a chargor and a receiver of charged assets is the agent of the chargor (even if the chargor enters into insolvency proceedings).**
- 49.2 A person dealing with a chargee, or with a receiver or administrative receiver, is entitled to assume, unless it has actual knowledge to the contrary, that:**
- (a) those persons have the power to do those things which they are purporting to do; and**
 - (b) they are exercising their powers properly.**

Commentary

- 1 Security documents normally provide that administrative receivers and receivers act as the agent of the chargor. Although that agency determines on the chargor enter into insolvency proceedings, this does not affect the ability of the receiver concerned to sell the charged assets⁹⁸. **Section 49.1** simplifies the position. It makes an administrative receiver and a receiver the agent of the chargor, and that agency is not terminated by the chargor entering into insolvency proceedings.
- 2 It is common in security documents for a provision to be inserted to protect third parties such as purchasers of assets from a receiver or administrative receiver. The purpose of **section 49.2** is to deal with this under the general law – in order to ensure its effectiveness.

⁹⁸ *Sowman v David Samuel Trust* [1978] 1 WLR 22.

50 Duties on enforcement

- 50.1 When enforcing a charge over charged assets, the person doing so (the enforcer) owes a duty to each interested person to take reasonable care of the charged assets which are the subject of the enforcement.**
- 50.2 An interested person is:**
- (a) the chargor (where it is in insolvency proceedings, acting through its insolvency officer – see part 10); and**
 - (b) any chargee of the charged assets other than the enforcer; and**
 - (c) any person (such as a guarantor) who is liable for all or part of the secured obligations concerned.**
- 50.3 When selling charged assets, the enforcer owes a duty to each interested person to obtain the best price reasonably obtainable for the charged assets at the time of sale.**
- 50.4 The enforcer can sell the charged assets when it decides to do so. It has no duty to accelerate or delay a sale even if to do so might increase the sale proceeds.**
- 50.5 Any claim for breach of these duties by the enforcer must be brought by or on behalf of an interested person for the amount of loss suffered by that person as a result of the breach of duty. For this purpose, loss suffered by an insolvent chargor includes loss suffered by its creditors (except to the extent that they are themselves interested persons and bring their own claim).**
- 50.6 An enforcer can sell charged assets to a person connected with the chargee or with anyone else with an interest in the charge. If it does so, it must have contemporaneous evidence from an independent person qualified to give it that it has obtained the best price reasonably obtainable for the charged assets at the time of sale.**
- 50.7 An enforcer cannot sell charged assets to the chargee. *[It should be permitted to retain the charged asset free of the chargor's equity of redemption subject to protections for the chargor.]***
- 50.8 Where the charged assets consist of financial collateral, this section is subject to the rules concerning enforcement contained in the legislation concerning**

financial collateral. It is also subject to Part VII of the Companies Act 1989 and to the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.

Commentary

- 1 Under the existing law, the duties of a chargee when enforcing the security are relatively clear, but there are areas of uncertainty, particularly where administrative receivers or receivers become involved.⁹⁹
- 2 The purpose of **section 50** is to set out the duties on enforcement broadly in line with the existing law, but to simplify and clarify them where necessary.
- 3 The duty is owed by the person enforcing the security. This may be the chargee, or it may be an administrator, administrative receiver or receiver. In the Code, this person is described as the enforcer (see **section 50.1**).
- 4 The enforcer's duties are owed to those who are described as interested persons. This means the chargor, other chargees and guarantors or other persons who are liable for all or part of the secured obligations concerned (see **section 50.2**).
- 5 The general duty of the enforcer to the interested persons is set out in **section 50.1**. When enforcing a charge, the enforcer must take reasonable care of the charged assets which are the subject of the enforcement. Under the current law, it is not clear the extent to which a general duty of this kind does apply in all cases of enforcement. The purpose of the Code is to put it beyond doubt that an enforcer does owe this general duty of care.
- 6 There is also a specific duty, when selling charged assets, to obtain the best price reasonably obtainable for the charged assets at the time of sale. This is provided for in **section 50.3**, and it broadly follows the approach taken in *Cuckmere Brick v Mutual Finance*¹⁰⁰.
- 7 **Section 50.4** contains an important limitation on the enforcer's duty. The enforcer can sell the charged assets when it decides to do so. It does not have to delay the sale even if to delay might increase the sale proceeds. In other words, it is up to the enforcer to decide when to sell. This is broadly the effect of the current law.

⁹⁹ Largely as a result of *Downsview Nominees v First City Corporation* [1993] AC 295

¹⁰⁰ [1971] Ch 949.

- 8 **Section 50.5** is concerned with the claim to be brought against the enforcer. Only an interested person can bring a claim. So for instance, a shareholder or a creditor is unable to do so. Where a chargor is insolvent, loss suffered by its creditors can constitute loss suffered by the company itself.
- 9 Under the existing law, there are particular rules where the sale is made to a connected person. In such a case, the enforcer has an affirmative duty to establish that the sale is made at the best price reasonable attainable. This is because of the obvious risk of collusion. **Section 50.6** gives effect of this principle by establishing that the enforcer must have contemporaneous evidence from a qualified independent person that it has obtained the best price reasonable obtainable. The Code has not attempted to define who is connected. The intention is that this should be given a common-sense interpretation.
- 10 Under the current law, a chargee cannot sell charged assets to itself. **Section 50.7** retains this principle, but there is significant support for allowing a chargee to retain the charged asset, free from the equity of redemption, by reaching agreement at the time with all interested persons. This needs to be explored further.
- 11 **Section 50.8** reminds the reader that there are particular rules concerning enforcement contained in the legislation concerning financial collateral and financial markets.

PART 10: INSOLVENCY PROCEEDINGS

General commentary

- 1 It is impossible to understand the law of security except in the context of insolvency law. The reason for taking security is to obtain a proprietary interest in assets which will survive the chargor's insolvency. It is therefore important that any Secured Transactions Code should deal with the interplay between the law of security and the law of insolvency.
- 2 But, equally, insolvency law is a large subject with detailed rules, and it is not practicable to reflect them all in the Code.
- 3 The approach taken in the Code is therefore a compromise. The purpose of part 10 is to explain why charges remain effective in an insolvency and then to explain in broad terms what limits insolvency law imposes on the effectiveness and enforceability of charges. It was considered helpful for the reader to know what the main limitations are which insolvency law places on charges; but the reader will need to go to the insolvency legislation and case law for the detail.

51 Effectiveness of charges

51.1 A charge creates a proprietary interest in the charged asset and it remains effective until it is extinguished, even if the chargor is in insolvency proceedings.

51.2 If the chargor does enter into insolvency proceedings, the rights of the chargee in relation to the charge are subject to the insolvency legislation.

51.3 In this Code:

(a) insolvency legislation means:

- (i) the Insolvency Act 1986 and secondary legislation made under it;**
- (ii) the European Insolvency Regulation (Regulation (EU) 2015/848 of 20 May 2015) as it may be amended from time to time; and**
- (iii) any other primary or secondary legislation in force in England from time to time relating to, or affecting, insolvency or reorganisation.**

(b) insolvency proceedings means:

- (i) where the chargor is a natural person, bankruptcy; and**
- (ii) in any other case, liquidation or administration;**

(c) insolvency officer means a trustee in bankruptcy, liquidator or administrator of a chargor;

(d) insolvency claw-back proceedings means the proceedings described in section 52.

Commentary

1 It is best to start with the definitions in **section 51.3**. This defines:

- insolvency legislation;
- insolvency proceedings;
- insolvency officer; and
- insolvency claw-back proceedings.

- 2 **Sections 51.1 and 51.2** set out the two basic principles which establish the relationship between the law of security and insolvency law.
- 3 The starting point is that a charge is a proprietary interest in the charged asset. It therefore remains effective in the chargor's insolvency proceedings (**section 51.1**). This follows from the basic principle that a charge is a proprietary interest (**section 2.1**) and that a proprietary interest binds an insolvency officer of the chargor (**section 2.2**). Personal claims against the chargor abate *pari passu*. But proprietary rights continue to be effective and enforceable.
- 4 Although this is this basic principle, insolvency law does place certain restrictions on the effectiveness and enforceability of a charge in insolvency proceedings. If the chargor does enter into insolvency proceedings, the rights of the chargee are therefore subject to the insolvency legislation (**section 51.2**).

52 Insolvency claw-back proceedings

52.1 Under the insolvency legislation, a charge may be set aside in whole or in part (and other remedies may be available) if:

- (a) the charge is a voidable preference (see Insolvency Act 1986, sections 239 and 340); or**
- (b) [*the charge secures old money*]; or**
- (c) the charge is a transaction at an undervalue (see Insolvency Act 1986, sections 238 and 339); or**
- (d) the charge is part of a transaction defrauding creditors (see Insolvency Act 1986, section 423).**

Commentary

- 1 Charges entered into in the period running up to the commencement of insolvency proceedings may be set aside under the claw-back provisions in the insolvency legislation. The purpose of **section 52** is to explain what the principal claw-back procedures are. It is intended to make the reader better able to understand how the claw-back procedures can impinge upon a charge. The detail is contained in the insolvency legislation.
- 2 Section 245 of the Insolvency Act 1986 applies to floating charges which secure money which has already been lent. The Code does not distinguish between fixed and floating charges. Consideration therefore needs to be given to a replacement to cover charges given to secure old money.

53 Limitations on enforcement

- 53.1 If the chargor is a company which goes into administration, there are limitations on the chargee's power to enforce the charge (see Insolvency Act 1986, paras 43 and 44 of Schedule B1).**
- 53.2 There are similar limitations where a small company proposes to enter into a voluntary arrangement (see Insolvency Act 1986, Schedule A1).**
- 53.3 [*Bank resolution proceedings*]**

Commentary

- 1 In practice, one of the important limitations on charges in an insolvency is the moratorium on enforcement contained in the insolvency legislation. Its main application is when the chargor goes into administration. It does not apply in a liquidation.

54 Use of charged assets by an administrator or liquidator

54.1 *It is envisaged that section 54 will contain a power for an administrator (and possibly a liquidator) to use a certain amount of charged assets in certain limited circumstances.*

Commentary

- 1 Under the existing law, certain persons who have claims against the chargor rank in priority to a floating chargee (but not to a fixed chargee). In two of these cases, priority is given to unsecured creditors of the chargor whose claims were owed before the insolvency proceedings. In the other case, priority is given to claims which are created after the debtor has entered into insolvency proceedings. The three categories of case are:
 - preferential creditors;
 - the prescribed part payable to unsecured creditors;
 - expenses of administration and, in certain circumstances, liquidation.
- 2 The Code does not distinguish between fixed and floating charges. One of the reasons it does not do so is that experience demonstrates that many of the problems caused by the current law stem from the requirement to draw a distinction between fixed and floating charges on an insolvency, and the uncertainties and difficulties which result from that.
- 3 It is therefore envisaged that the legislation which will bring the Code into force will repeal the statutory provisions which give priority to preferential creditors, unsecured creditors and insolvency practitioners over floating charges.
- 4 This issue was discussed in the second discussion paper on Secured Transaction Reform published by the Financial Committee of the City of London Law Society in February 2014. That paper raises a number of issues which need to be discussed. They may result in a decision that nothing is needed to replace the existing provisions. Alternatively, it may be necessary to replace the current provisions with a limited power to use charged assets in limited circumstances and subject to safeguards. The Code will be updated when those discussions have become more advanced.