The Law Commission
(LAW COM No 296)

COMPANY SECURITY INTERESTS

Presented to the Parliament of the United Kingdom by the Secretary of State for Constitutional Affairs and Lord Chancellor by Command of Her Majesty
August 2005

Cm 6654

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The Law Commission was set up by the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

The Law Commissioners are:

The Honourable Mr Justice Toulson, *Chairman*
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The terms of this report were agreed on 7 July 2005.

The text of this report is available on the Internet at:

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THE LAW COMMISSION

COMPANY SECURITY INTERESTS

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SUMMARY

1. In 2002, the Department of Trade and Industry asked the Law Commission to consider the case for reforming the law on company charges. This followed a recommendation in the Final Report of the Company Law Review Steering Group. The Group reported that it had received substantial criticism of the current system for registering charges and for deciding priority between them. Radical reform was needed but it had not had time to consult on detailed proposals.

2. We published a consultation paper (CP No 164) in 2002, and a more detailed consultative report (CP No 176) in 2004. These are available on our website: www.lawcom.gov.uk.

3. Here we summarise our main proposals. A fuller summary is available in Part 1 of the report, paragraphs 1.27 – 1.44. Part 1 also provides cross-references to the paragraphs of the report where the issues are discussed in detail.

A NEW SYSTEM OF ELECTRONIC NOTICE FILING

4. The current system of registering charges is unduly cumbersome, slow and expensive. It involves the submission of paper documents, although the register itself is electronic. It requires Companies House staff to check through lengthy legal documents and to issue a conclusive certificate of registration.

5. Under the new scheme we recommend:

   - Electronic filing will replace the current paper-based system.

   - To register a charge, it will be necessary only to send brief particulars of the charge in a simple, electronic format. The original charge document will not be sent.

   - The Registrar of Companies will no longer be responsible for checking the particulars that have been filed and will not issue a conclusive certificate. It will be up to the party who files (normally the lender) to ensure that the financing statement identifies the correct company as debtor and that the description is adequate to cover the property subject to the charge. Provided the financing statement does identify the correct company, the charge will be validly registered in respect of the property listed in the particulars.

   - The property may be described in general terms, but there will be a facility for parties who wish the description to cover precisely what is in the charge agreement to include the exact terms of the agreement.

   - Formal responsibility for registration, and the rarely-applied criminal liability for failure to register, will be removed from the company. It will be up to the lender taking the charge to file if it wishes to protect its security. If the company becomes insolvent before the charge is registered, the charge will not be effective against the administrator or liquidator. Unregistered charges will also be vulnerable to loss of priority.

REMOVING THE 21 DAY TIME LIMIT

6. Under current law, unless a registrable charge is registered within 21 days, it is void against a liquidator or administrator. This causes inconvenience: each year, Companies House rejects around 3,000 late applications. Lenders must either re-execute the paperwork or apply to the court to register out of time. If a charge is registered within the 21-day period, its priority depends on when it was created, not when it was registered. A charge-holder that registers first could find itself subject to a charge created up to three weeks earlier that it knew nothing about.

7. Under the new scheme:

- The formal time limit for registration (and the need for court applications for late registration) will be removed.

- There will be no period of 'invisibility' between submission of the particulars and their appearance on the register. It will be possible to search quickly and reliably on-line.

- Lenders may file in advance of the transaction. They may therefore protect their position during negotiations. Similarly, a single filing may cover a number of similar transactions between the same parties, removing the need for multiple filings.

EXTENDING THE LIST OF REGISTRABLE CHARGES

8. The list of charges that need to be registered is out-of-date. The Companies Act 1985 omits some charges which are often used. There is also uncertainty about what should be registered and what should not.

9. Under the new scheme:

- All charges are registrable unless specifically exempted.

- The principal exemptions will be for some charges over registered land and over financial collateral: see below.

CLEARER PRIORITY RULES

10. The Companies Act 1985 does not lay down clear rules about what happens when two or more creditors have registered charges over the same property. Priority depends on complex common law rules that are not suited to modern financing methods. Priority between a secured lender and someone who buys property that is subject to a charge is also unclear.

11. Under the new scheme:

- Priority between competing charges will be by date of filing (unless otherwise agreed between the parties involved). This will simplify the current law and will remove the current '21-day period of invisibility'.

- The distinction between fixed and floating charges will be preserved, principally because of its importance in insolvency.

- In the case of a floating charge, it will be unnecessary to rely on a 'negative pledge clause' to prevent subsequent charges gaining priority. It will also be unnecessary to employ 'automatic crystallisation clauses', with their uncertain effects, to protect property subject to a floating charge from seizure by judgment creditors.

- The effect of registration on the rights of a person who buys the property without knowing of the charge will be clarified. If the charge is fixed but has not been registered, it will not affect a buyer who does not know of it; if the fixed charge has been registered it will be binding on the buyer.

- Some charges may also be registered in specialist registers, such as those covering unregistered land, registered aircraft and ships, and intellectual property. The regulations clarify that normally any priority rules set out in the specialist legislation will apply.

LAND

12. At present, a company charge cannot be registered in the Land Registry until it has been registered with Companies House and a certficate of registration has been issued. This causes administrative problems for the Land Registry. The process is delaying the development of e-conveyancing.

13. Under the new scheme:

- If a charge over registered land is registered in the Land Registry, it will not need to be registered in the Company Security Register as well. Instead, the Land Registry will automatically forward to Companies House its information about charges over land owned by companies. The information will be available to those searching the Company Security Register.

SALES OF RECEIVABLES

14. 'Receivables' (that is, sums owed to the company by its various debtors) are an important asset and 'receivables financing' is enormously important, especially for small and medium enterprises. At present the law distinguishes between charges over 'book debts', which require registration, and sales of book debts, for example to a factor, which do not have to be registered. The two, however, perform almost identical economic functions. The priority rules are unsuited to modern receivables financing. They mean that a receivables financier must make enquiries of the 'account debtor', and notify the debtor of the arrangement, or risk losing out to a second financier. Restrictions on the assignment of receivables frequently limit the use that companies may make of this efficient form of financing.

15. Under the new scheme:

- Sales of receivables of the kind which factoring and discounting agreements cover will be brought within the scheme. This means that they must be registered to be valid on insolvency.

- Their priority will be determined by the date of filing.

- Provisions in the contract generating the receivable that purport to restrict its assignment will no longer be effective against the assignee.

SCOTTISH AND OVERSEA COMPANIES

16. The current provisions requiring registration of charges created by companies registered outside Great Britain over their property in England and Wales have proved highly unsatisfactory. The principal problem is that there is great uncertainty about when a company has a place of business here, so that its charges must be registered. The result is that particulars of many charges are sent to Companies House for registration as a precaution, but the information is not placed on the register and is not available to searchers.

17. Under the new scheme:

- Charges created by Scottish and oversea companies over their property in England and Wales will fall within the scheme. The information will be placed on the register and made available to searchers. (The provisions on sales of receivables will only apply to companies registered in England and Wales.)

- Charges created by companies registered in England and Wales over their property in other jurisdictions will remain registrable, but without prejudice to rights acquired in those assets by the secured party or third parties according to the law of that jurisdiction.

FINANCIAL COLLATERAL

18. Those taking security over financial collateral such as investment securities and bank accounts need to do so quickly and with certainty. Purchasers of investment securities also need to have confidence that they will not be affected by prior rights over the property without having to conduct elaborate enquiries. At present there is some uncertainty about when charges over financial collateral are exempt from registration under the regulations that implement the European Directive on Financial Collateral Arrangements. There is also uncertainty over the priority rules between competing charges and between chargees and purchasers. This is a particular problem in financial markets, where it is essential that investment property is readily transferable.

19. Under the new scheme:

- Registration will not be needed where the chargee has obtained ‘possession or control’ within the meaning of the Directive, or has ‘control’ of it as defined by the regulations we propose.

- A chargee will have control of financial collateral if the company can no longer deal freely with the assets free of the charge.

- The regulations set out ways in which the chargee can obtain control over particular types of financial collateral.

- A security which is perfected by control will have priority over one merely perfected by filing; priority between charges perfected by control will depend on the order in which control was obtained.

- Purchasers of securities or securities entitlements for value and without notice of existing security interests will not be affected by them.

THE BUSINESS CASE

20. There is a clear business case for reform. The move to electronic filing, and the abolition of the certificate of registration and the 21-day period for registration, will result in direct savings to lenders, companies and Companies House. The other changes will make the law more certain and reliable. Overall the cost of secured borrowing will be reduced.

FURTHER WORK

Title-retention devices

21. In our Consultative Report we proposed to include title-retention devices such as finance leases, hire purchase and conditional sale agreements within the scheme. This proved controversial. Many people thought it would be illogical to have one set of rules applying to title-retention devices entered into by companies, and another for those involving unincorporated businesses and individuals. The most important reason for requiring title-retention devices to be registered is to protect purchasers. We intend to reconsider this issue in the context of a broader project on transfer of title by non-owners.

Statement of rights and remedies

22. The Consultative Report included a draft statement setting out the rights and duties of the parties to a security agreement, particularly following default. Again this proved controversial, and we are not proceeding with it as part of this scheme. We intend to consult further to see how much support there would be for a restatement of the existing law which would clarify English law for its users and which might serve as a model for European and international harmonisation.

Charges created by unincorporated businesses and individuals

23. Our terms of reference asked us to consider whether any new scheme for company charges should be extended to unincorporated businesses and individuals. At present, charges granted by non-companies must comply with the Bills of Sale Acts 1878-1891. Our consultation paper examined these provisions and concluded that they are out-of-date, unnecessarily complicated and unduly restrict the forms of secured borrowing available to small businesses.

24. We continue to believe that there is a strong case for replacing the Bills of Sale Acts, but in the time available we have not been able to devise detailed recommendations. As far as consumers are concerned, we recommend that the Department of Trade and Industry consider the issue. For unincorporated businesses, we will return to the subject when we know whether our proposals for companies will be implemented.

TERMS AND ABBREVIATIONS USED IN THIS REPORT

Cash	In the context of financial collateral, this means sums in an account (such as a bank account), money market deposits and sums due under 'netting arrangements'.
Charge	Unless the context requires otherwise, this includes a mortgage.
Chargee	The lender or creditor who has taken a charge or mortgage.
Chargor	The company that creates the charge.
CLLS FLC	City of London Law Society Financial Law Committee. This was formerly known as the City of London Law Society Banking Law Sub-Committee.
Company Security Register	The proposed new register at Companies House for company charges and sales of receivables which are registered under the notice-filing scheme. It would replace the company charges register created under Part XII of the Companies Act 1985.
CP	Registration of Security Interests: Company Charges and Property other than Land (2002), Law Commission Consultation Paper No 164.
CR	Company Security Interests: A Consultative Report (2004), Law Commission Consultation Paper No 176.
CR draft regulations	The draft regulations set out in the Consultative Report (above) for the purposes of consultation. They are referred to as 'CR draft regs' in the footnotes.
Crowther Report	Report of the Committee on Consumer Credit (1971) Cmnd 4596.
Diamond Report	A L Diamond, A Review of Security Interests in Property (1989), HMSO, London.
Draft regulations	The draft regulations in Appendix A of this report, which we recommend should be made under the powers to be included in the proposed Company Law Reform Bill. These are referred to as 'draft regs' in the footnotes.
EBRD	European Bank for Reconstruction and Development.
FCAR	Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003 No 3226.

FCD	European Directive on Financial Collateral Arrangements, Directive 2002/47/EC of the European Parliament and Council of 6 June 2002, OJ L 168/43 ('the Financial Collateral Directive').
FDA	Factors & Discounters Association.
Filing	The submission of a financing statement for registration in the Company Security Register.
Financial Collateral	Financial Collateral is defined in the FCD as 'financial instruments' (for example, securities) and 'cash'.
FMLC	Financial Markets Law Committee.
NZPPSA	New Zealand Personal Property Security Act 1999 (as amended).
OPPSA	Ontario Personal Property Security Act (RSO 1990, Chapter P10 as amended).
Perfected, Perfection	'Perfected', in relation to a charge, means that all necessary steps have been taken to render it effective against third parties and in insolvency proceedings under the law of the jurisdiction in question; and 'perfection' has a corresponding meaning.
PPSA	Personal Property Security Act. The term PPSAs is used as collective term for the various adaptations of the model PPSA by Canadian provinces and the New Zealand Personal Property Security Act.
Quasi-security	A generic term for transactions that perform the same economic function as a security but have a different legal form. See security interest, below.
Receivables	The term may include any monetary obligation owed to the company wishing to raise finance. In our scheme, the term 'sale of receivables' is given a narrower definition, to cover only those monetary obligations arising from goods or services supplied (with the addition of the supply of energy and brokerage fees, which might not otherwise be included).
RoT	Retention of title.
Securities	Investment property such as shares or bonds.
Security	A charge, mortgage, pledge or outright sale of receivables, except where the context requires otherwise.

Security Interest ('SI')	In the CR, as in the UCC and the PPSAs, this was used to denote any transaction that served the same function as a security (an 'in-substance' SI), or which was treated in the same way (a 'deemed' SI). Thus in the CR, a finance lease was an 'in-substance' SI and a sale of receivables was a 'deemed' SI.
SLC	Scottish Law Commission.
SPPSA	Saskatchewan Personal Property Security Act 1993.
Title-retention device	A transaction under in which a supplier retains title to goods, so that it can retake them if the other party defaults in payment. If there is no default, the intention is that the other party should ultimately obtain title to or keep the goods for their economic life. It includes conditional sales, finance leases, hire-purchase and retention-of-title clauses.
UCC, Revised Article 9	Uniform Commercial Code, Article 9, 1999 Official Text. This sets out a system of notice filing for security over personal property in the United States of America. References are normally to Revised Article 9, which has been adopted in all States.

THE LAW COMMISSION

COMPANY SECURITY INTERESTS

To the Right Honourable the Lord Falconer of Thoroton, Secretary of State for Constitutional Affairs and Lord Chancellor

PART 1
INTRODUCTION

1.1 This report is about the system for registering mortgages and charges over property owned by companies and about the 'priority' rules that apply when there is more than one mortgage or charge over the same property. It also deals with similar issues when a company sells it 'receivables', for example under a factoring agreement.

1.2 Charges and other forms of security over the property of companies are of great practical importance. As the Cork Committee put it, 'credit is the lifeblood of the modern industrialised economy'[1] - words that are as true today as when they were written in 1982. Some borrowers, particularly well-established public companies, are able to borrow readily on an unsecured basis, but for many smaller enterprises credit can be obtained on significantly better terms – and sometimes can only be obtained – if the borrower is able to offer security to the lender. Even public companies frequently make use of forms of security in particular situations, and secured financing is a crucial feature of financial markets.[2] As Professor Sir Roy Goode comments:

> Security in personal property has become enormously important both within a country and in relation to cross-border transactions. Without an adequate legal regime for personal property security rights, it is almost impossible for a national economy to develop.[3]

1.3 It is generally agreed that it is important that there be a public record of charges created by companies over their property. As Professor Diamond reported:

[1] Report of the Review Committee on Insolvency Law and Practice (1982) Cmnd 8558, para 10.

[2] We are most grateful to Mr Philip Wood for graphic information on the use of secured lending.

[3] R Goode, 'Security in Cross-Border Transactions' (1998) 33 Texas ILJ 47, referred to in I Davies, 'The reform of English personal property security law: functionalism and Article 9 of the Uniform Commercial Code' (2004) 24 LS 295. Both authors note that this thinking has informed initiatives by the World Bank, the European Bank for Reconstruction and Development, UNCITRAL and UNIDROIT.

> … the general requirement for the registration of charges under the Companies Act commands almost universal support and there is no demand for its abolition. Apart from the objective of providing information for persons proposing to deal with the company so that they, or credit reference agencies on their behalf, can assess its creditworthiness, persons considering whether to provide secured credit can find out whether the proposed security is already the subject of a charge; by the same token, a registration system benefits the company itself if it is enabled to give some sort of assurance to a prospective secured creditor that the property it is offering as security is unencumbered. Registration can also ease the task of a receiver or liquidator in knowing whether to acknowledge the validity of an alleged mortgage or charge, and does away with the risk of fraud by inventing a security only when a receiver is appointed or the company goes into liquidation. One can also recognise that, in addition to the use of information by financial analysts and persons considering whether to invest in a company, there is today a general climate of opinion in favour of public disclosure of companies' financial activities.[4]

1.4 It is also important that the law should set out clear rules to resolve disputes when two or more parties lay claim to the same property. This may occur, for example, when the same asset has been charged to two separate lenders, and where charged property has been sold to an innocent buyer. Priority disputes may arise rarely but the rules have a significant impact on the steps that potential secured lenders and buyers of company property have to take to safeguard their interests.

1.5 Despite its importance, the current law on company security interests has been severely criticised for many years.[5] The scheme for registering company charges dates back to 1900 and is now inappropriate to modern needs.[6] It is particularly inefficient in two ways. First, it requires charge documents to be submitted in paper form, although the register of company charges maintained at Companies House is electronic. Secondly, registry staff must check the particulars submitted against lengthy legal documents before the registrar issues a conclusive certificate of registration. This requires a significant number of staff and is, in our view, unnecessary and impossible to justify. A system of electronic on-line registration, with the party filing being responsible for ensuring that the information registered is accurate, would be far more efficient.

[4] See A L Diamond, *A Review of Security Interests in Property* (1989) (the 'Diamond Report'), para 11.1.5.

[5] See Report of the Committee on Consumer Credit (1971) Cmnd 4596 (the 'Crowther Report'), Parts IV and V; and the Diamond Report. See also Law Commission, Registration of Security Interests: Company Charges and Property other than Land (2002) Consultation Paper No 164 (the 'CP'), Part 3 and Company Security Interests, a consultative report, Consultation Paper No 176 (2004) (the 'CR'), paras 2.3-2.6.

[6] Companies Act 1900, s 14. It is currently set out in Part XII of the Companies Act 1985.

1.6 Other serious criticisms can be made of the current law. The requirement to send particulars of a charge for registration within 21 days and the provisions for late registration cause a great deal of unnecessary trouble and expense each year. The scheme for registering charges over the property of 'oversea' companies requires charges to be registered if the company has a place of business here whether or not it has duly registered that place of business. This results in particulars of large numbers of charges being sent to Companies House as a precaution. The information is not recorded and is not available to searchers. Large numbers of trust deeds entered into by corporate members of Lloyd's have to be registered though this produces no apparent benefit. But at the same time the list of charges that need to be registered reflects nineteenth century commercial practice, and omits charges over kinds of property that are commonly used as security today.[7] There is uncertainty over which charges over receivables have to be registered, while sales of receivables, which perform a very similar economic function to charges, do not have to be registered at all.

1.7 The current rules to resolve these priority issues are unnecessarily complex. They depend, for example, on distinguishing between legal and equitable interests and whether certain buyers should be expected to check the register. They may also take lenders by surprise, as where a charge-holder that registers first finds it is subject to a charge created up to three weeks earlier that it knew nothing about. The rules for charges over receivables and sales of receivables grant priority to those who notify account debtors, a process increasingly unsuited to the needs of modern receivables financing.

1.8 Registration of security has been the subject of two major reports, the Crowther Report and the Diamond Report.[8] Both recommended that the current law should be replaced by a scheme of 'notice-filing' and priority rules modelled on Article 9 of the American Uniform Commercial Code. This system has been adopted (with variations) in most Canadian provinces[9] and, more recently, in New Zealand.[10]

[7] J de Lacy comments that the list of charges set out in the Companies Act 1985, s 396 'had effectively crystallised by 1928'. See 'Reflections on the ambit and reform of Part 12 of the Companies Act 1985 and the doctrine of constructive notice' in J de Lacy (ed*), The Reform of United Kingdom Company Law* (2002) 337.

[8] See above, para 1.3, note 4.

[9] Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Ontario, Prince Edward Island and Saskatchewan, plus Northwest Territories, Nunavut and Yukon Territory.

[10] New Zealand Personal Property Securities Act 1999, amended by the Personal Property Securities Amendment Act 2000, the Personal Property Securities Amendment Act 2001, and the Business Law Reform Act 2004. It is also being considered for adoption by Singapore: see G McCormack, 'Reforming the Law of Security Interests: National and International Perspectives' [2003] Singapore JLS 1. (We understand that decisions on reform in Singapore are awaiting the outcome of our reform exercise.) It has also influenced the Model Law promulgated by the European Bank for Reconstruction and Development , which adopts priority by date of filing. The Model Law has been adopted in whole or in part in several countries of Central Europe.

1.9 Our recommendations draw on the best and most relevant features of those schemes, tailored to the particular needs of company financing in England and Wales. We recommend a scheme of electronic 'notice-filing' for charges created by companies. The principle behind 'notice-filing' is that the creditor should file notice of a charge rather than register the charge itself. This ensures that the process of registration is simple. It is limited to what other creditors need to know and does not get bogged down in the detail of legal documentation. It will be done electronically, which is quick and inexpensive. The information appears immediately, removing the dangers associated with delay. The time limit for registration will be removed. Lenders may also file in advance of creating a charge, so as to protect their position during negotiations. Furthermore, they may cover several transactions with the same chargor in a single notice.

1.10 As far as priority rules are concerned, the general principle underlying the scheme is that the party who registers first should gain priority. When the contest is between a chargee and someone who has bought the property that is subject to the charge, priority will for the most part depend on whether the charge is registered and, if it was, whether the charge permitted the chargee to sell the property free of the charge (a 'floating charge', as opposed to a fixed charge which permits sale only with the chargee's agreement to the specific sale).

1.11 There are distinct rules for charges over investment securities and other forms of 'financial collateral', crafted to meet the requirements of European Community legislation. We clarify when a charge over financial collateral needs to be registered; the rules governing the priority of competing charges over financial collateral; and when a person who buys the property without being aware of the charge will be affected by it.

1.12 We recommend extending the scheme to cover outright sales of receivables as well as company charges. It would apply, for example, where a company sells its debts to a factor or invoice discounter. At present, a factor can only be sure of its priority if it writes to each account debtor. In future it will be able to secure its position more cheaply and easily by filing in the register. This meets an urgent need and is strongly supported by receivables financiers.[11]

1.13 The scheme we recommend would replace Part XII of the Companies Act 1985. We hope it can be implemented by the Company Law Reform Bill that the Government intends to introduce.[12] These and the other changes recommended in this report will bring real benefits to companies, financiers who lend to them, other parties who deal with them and the economy as a whole.

[11] See further below, paras 2.34-2.39.

[12] See the Queen's Speech of 17 May 2005.

1.14 In this report we do not advocate such radical changes as did the Crowther and Diamond reports. They recommended that the scheme should apply to a wider range of transactions that perform a similar economic function to charges but which current law does not regard as 'security'. These 'quasi-securities' would include finance leases, hire purchase, conditional sales and retention of title clauses. We think there may be a case for extending the scheme to such transactions at a future date, but the issue requires further study.[13] We also think that any such extension should apply to all business transactions, not just those entered into by companies. The earlier reports also recommended that notice-filing should apply to security interests created by unincorporated businesses and individuals. At least so far as charges created by unincorporated businesses are concerned, we agree in principle. The law is so technical and restrictive that an unincorporated business wishing to borrow on the security of its assets (other than land) will often come under pressure to incorporate.[14] However more work is needed on the details of the scheme and we do not make final recommendations on it in this report.[15]

TERMS OF REFERENCE

1.15 The reference for this project came from the Secretary of State for Trade and Industry, following a recommendation in the Final Report of the Company Law Review Steering Group.[16] That Group developed a set of provisional proposals to establish a 'notice-filing' scheme, but did not have the time to consult on them widely.[17] Our terms of reference require us to:

(1) examine the law on the registration, perfection and priority of company charges;

(2) consider the case for a new scheme of registration and priority of company charges, including charges created by

(a) companies having their registered office in England or Wales, wherever the assets charged are located; and

(b) oversea companies and companies having their registered office in Scotland, where the charge is subject to English law;

(3) consider whether such a scheme should apply both to security in the strict sense and to 'quasi-security' interests such as conditional sales, retention of title clauses, hire-purchase agreements and finance leases, including the extent to and means by which such interests should be made subject to the law governing securities;

[13] See further below, paras 1.60-1.66.

[14] Charges created by unincorporated businesses are subject to the Bills of Sale Act 1878 and Bills of Sale Act (1878) Amendment Act 1882. The Crowther Report commented that 'it is difficult to imagine any legislation possessing more technical pitfalls' (para 4.2.12).

[15] See further below, paras 1.46-1.57.

[16] *Modern Company Law for a Competitive Economy: Final Report* (2001) URN 01/942 ch 12.

[17] See CP 164 paras 1.12-1.15.

(4) examine the law relating to the granting of security and 'quasi-security' interests by unincorporated businesses and individuals over property other than land, including the feasibility of extending any new scheme for company charges to such interests, and the extent to and means by which such 'quasi-security' interests should be made subject to the law governing securities; and

(5) make recommendations for reform.

THE 2002 AND 2004 CONSULTATION PAPERS

1.16 This report is made in the light of responses to two formal consultation documents.[18] We published our first consultation paper, Registration of Security Interests: Company Charges and Property other than Land ('the CP') in July 2002.[19] It provisionally proposed a scheme of 'notice-filing' and priority rules similar to those recommended by the Crowther and Diamond reports. The scheme would replace both the current scheme of registration of charges created by companies under Part XII of the Companies Act 1985 and the scheme for charges created by non-corporate debtors over personal property under the Bills of Sale Acts. We asked whether a 'functional approach' should be taken, so that devices such as finance leases that fulfil a similar economic function to security ('quasi-securities') should also be subject to the scheme of registration and priority. We also asked whether a legislative statement of the law of security would be desirable as part of any reforms.[20]

1.17 Our proposals to reform the scheme for registering company charges received broad support, though consultees had reservations on particular points and some raised questions about the effects of the scheme. There was also broad support for extending the scheme to cover unincorporated businesses. The proposal to include quasi-securities proved more controversial. A particular issue for many was whether the extension to quasi-securities should form part of the 'companies-only' scheme or should await extension of the scheme to unincorporated debtors. The largest group of consultees said that they wished to see how the scheme would operate in more detail before deciding whether it was justified.

[18] We also circulated a number of draft papers to individuals and organisations that had shown interest in the project. These formed the basis of discussion at a series of seminars: see CR para 1.13.

[19] Registration of Security Interests: Company Charges and Property other than Land (2002) Consultation Paper No 164 ('the CP').

[20] The alternative approach taken by the Company Law Review Steering Group, of making adjustments to the existing system, was dealt with in an Appendix to CP 164.

1.18 Therefore our consultative report, Company Security Interests: a consultative report ('the CR')[21] set out detailed provisional proposals covering both company charges and 'quasi-securities'. It dealt with both registration and priority, with detailed provisions on financial collateral. It also included the statement of rights and remedies that we thought would be desirable. The CR contained draft regulations covering each aspect of the scheme. It did not deal in any detail with security interests created by individuals and unincorporated businesses, but repeated the earlier proposal that the scheme for companies should be extended to unincorporated debtors as soon as practicable.

RESPONSES TO THE CONSULTATIVE REPORT

1.19 We received 70 responses to the CR, including 21 from practitioners and practitioner organisations, 10 from banks and banking organisations and 12 from academics. Some responses were very detailed. The Financial Law Committee of the City of London Law Society examined our proposals in particular depth,[22] and their response was adopted by a further 11 respondents, some of whom added comments and clarifications of their own. We are also grateful for the detailed responses we received from financial organisations, including the Factors and Discounters Association, the Finance and Leasing Association, CREST, HPI and the British Bankers' Association. Inevitably, we received more responses from lawyers and lenders than from companies, though the Confederation of British Industry sent a considered response. A full list of respondents is to be found in Appendix B.

1.20 The consultative report was a long, complex document and, in parts, it was controversial. It was not easy to analyse the responses. Most consultees agreed with our conclusion that the current law has significant weaknesses,[23] but there was less agreement on what should replace it. In the light of the responses to the earlier consultation paper and much informal discussion with interested parties, we believe that the reactions to our proposals may be summarised as follows.

[21] Company Security Interests, a consultative report, Consultation Paper No 176 (2004) (the 'CR').

[22] Referred to hereafter as CLLS FLC. We would also like to thank the CLLS Insolvency Law Committee, the Law Society Company Law Committee, Clifford Chance, DLA LLP and Graham McBain for their detailed comments.

[23] See CR para 2.6.

Registration

1.21 There was clear support for our provisional recommendations on issues relating to the registration of charges. Support for changing to a system of electronic registration was almost unanimous. There was general support for removing the obligation on the company to ensure that particulars of charges were sent for registration. Registration should be a matter of choice for the chargee, but with the sanctions that an unregistered charge would be at risk of loss of priority and ineffective in the company's insolvency. There was widespread if sometimes reluctant recognition that it is no longer justifiable for the Registrar of Companies to be responsible for checking the particulars of charges and issuing a certificate of registration. The responsibility for registering correctly should lie on the chargee, provided that it is made easy for the party who files (normally the chargee or its agent) to provide a correct description of the collateral.

Priority

1.22 There was wide support for a simplified scheme of priority by date of filing. Not all respondents agreed, but those who did not support the recommendations usually argued that change was not needed because priority disputes were uncommon, rather than that our proposals were wrong. Several consultees supported changes that would strengthen the position of the floating charge, making devices such as negative pledge clauses and automatic crystallisation clauses unnecessary.

1.23 There was concern, however, at proposals that would have made it possible for any charge to permit the company to dispose of its assets free of the charge. The proposals would have made it unnecessary for lenders to take both a fixed and a floating charge. The concern was not about the substance of the proposed change but because of the implications for the law of insolvency, where the distinction between floating and fixed charges is deeply imbedded. There have recently been major upheavals to the law of insolvency and consultees were reluctant to see any further changes.

Financial collateral

1.24 There was strong support for our proposals on financial collateral, even from bodies opposed to some other aspects of the scheme. They welcomed our proposals to provide greater clarity about when a secured party has 'control' of financial collateral (and so is exempt from the need to register the charge) and on the associated rules of priority. That said, it was pointed out that there were some technical difficulties with the draft regulations.

Sales of receivables

1.25 Views on whether the scheme should provide for filing of outright sales of receivables, and whether the priority of competing interests should be governed by the date of filing, were divided. Some were strongly in favour, others wholly or partly opposed. There were equally divergent views on our proposal that any contractual prohibition on assignment of a receivable should be of no effect against an assignee.

Recommendations that were not widely supported

1.26 Other provisional recommendations in the CR received less support. There was considerable opposition to the proposed obligation on the secured party to give information about the amount due under a charge and the collateral subject to it. There was also opposition to the proposal to remove from the registration scheme all charges over assets such as land, registered aircraft, registered ships and the forms of intellectual property for which there is a specialist mortgage register. There was only limited support among practitioners or the finance industry for including title-retention devices (such as finance leases, hire purchase, conditional sales and retention of title clauses) in a companies-only scheme.[24] There was also opposition to including a statement of rights and remedies in the companies scheme. Some of the opposition seemed to be based on a misunderstanding of the effects of the scheme; some was to particular aspects of it (in particular the mandatory rules). There was some support, however, for a statutory restatement that would (in reality or perception) be closer to existing law, particularly if it extended to all security, not just that created by companies.[25]

SUMMARY OF OUR RECOMMENDATIONS

1.27 In the light of the consultation, we recommend that there should be a new system of electronic notice-filing for company charges. The charge document should no longer be submitted. The registry should not be responsible for checking the particulars submitted and conclusive certificates of registration should no longer be issued.

1.28 Priority should be linked to the date of registration. The opportunity should be taken to deal with various problems that arise under the current law and generally to clarify and simplify it. For the time being the distinction between fixed and floating charges should be preserved, particularly in the context of insolvency, but the scheme should make the floating charge simpler and more effective as a security.

1.29 The scheme to be introduced for companies should apply to 'traditional' security interests such as charges, mortgages and pledges, and to sales of receivables. It should not affect title-retention devices such as finance leases or retention of title clauses. It should not include rules giving super-priority to purchase-money security interests nor a statement of the rights and remedies of the parties to a security agreement. Registration and priority of title-retention devices and a legislative codification of the law of security will be considered further in future reports.

1.30 In the light of the limited nature of the scheme, the draft regulations should revert to the traditional language of charges and pledges and should avoid using concepts that are necessary only for the wider scheme envisaged by the CR.

[24] Including our proposals in relation to uniquely identifiable assets (i.e. motor vehicles). The proposals to give purchase-money security interests priority over earlier-registered security interests, which were included principally to protect those employing title-retention devices, were criticised as unduly complex.

[25] This would include a statement of the types of security that can be taken and the kinds of obligations that can be secured, which were not included in the draft regulations in the CR.

1.31 We repeat our strongly-held view that, as soon as possible, there should be further legislation to extend the scheme recommended for company charges to charges created by unincorporated businesses; but we indicate that further work is needed on this. The introduction of the companies–only scheme should not wait on it.

PRINCIPAL FEATURES OF THE SCHEME WE RECOMMEND

1.32 The principal features of the scheme recommended in this report for the registration of company charges over property in general are:

(1) Electronic filing will replace the current paper-based scheme of registration of company charges.[26]

(2) To register a charge, it will be necessary only to send brief particulars of the charge in a simple, electronic format. The original charge document will not be sent.[27]

(3) There will be no period of 'invisibility' between submission of the particulars and their appearance on the new 'Company Security Register'. It will be possible to search quickly and reliably on-line.[28]

(4) Formal responsibility for registration, and the rarely-applied criminal liability for failure to register, will be removed from the company. It will be up to the lender taking the charge (the 'chargee') to file if it wishes to protect its security.[29]

(5) Failure to file before insolvency will render the charge ineffective against an administrator or liquidator. An unregistered charge will also be ineffective against execution levied by judgment creditors.[30]

(6) The Registrar of Companies will no longer be responsible for checking the particulars that have been filed. It will be up to the party who files (normally the chargee or its agent) to ensure that the financing statement identifies the correct company as debtor and that the description filed is adequate to cover the property subject to the charge. Provided the financing statement does identify the correct company as the debtor, the charge will be validly registered in respect of the property listed in the particulars.[31]

[26] See paras 3.69-3.71.

[27] See paras 3.97-3.120.

[28] See paras 3.92-3.93.

[29] See para 3.77.

[30] See para 3.78.

[31] See paras 3.74-3.76 and 3.124-3.131.

(7) The property may be described in general terms, but there will be a facility for parties who are concerned that the filing should cover precisely what is in the charge agreement to include the exact terms of the agreement.[32]

(8) The current list of charges that must be registered will be replaced by a provision that any charge is registrable unless specifically exempted.[33]

(9) The formal time limit for registration (and thus the need for court applications for late registration) will be removed.[34]

(10) It will be possible to file in advance of the transaction and a single filing may cover more than one transaction between the same parties.[35] This will be particularly important for sales of receivables, discussed below.[36]

1.33 As to the priority of charges and other security over property in general:

(1) Priority between competing charges will be by date of filing (unless otherwise agreed between the parties involved). This will simplify the current law and will remove the current '21-day period of invisibility'.[37] In the case of a floating charge, it will be unnecessary to rely on a negative pledge clause in order to prevent subsequent charges gaining priority.[38]

(2) It will no longer be necessary to employ 'automatic crystallisation clauses', with their uncertain effects, in order to protect property subject to a floating charge from seizure by judgment creditors.[39]

(3) The effect of registration on the rights of a person who buys the property without knowing of the charge will be clarified. If the charge is fixed but has not been registered, it will not affect a buyer who does not know of it; if the fixed charge has been registered it will be binding on the buyer.[40]

[32] See paras 3.107-3.109.

[33] See paras 3.14-3.16.

[34] See paras 3.79-3.82.

[35] See paras 3.86-3.91.

[36] See para 1.36 and Part 4.

[37] See paras 3.149-3.155.

[38] See paras 3.177-3.180.

[39] See paras 3.201-3.204.

[40] See paras 3.210-3.224.

1.34 Charges over unregistered land, registered ships and aircraft, and all kinds of intellectual property, will remain registrable at Companies House.[41] It will no longer be necessary to register a fixed charge over registered land at both Companies House and the Land Registry. Information about company charges over land registered at the Land Registry will be forwarded automatically to Companies House so that the information will be available to those searching the Company Security Register.[42] The priority of competing charges over these types of property will be set out in clear rules.[43]

1.35 Charges created by companies registered in England and Wales over their property in other jurisdictions will remain registrable, but without prejudice to rights acquired in those assets by the secured party or third parties according to the law of that jurisdiction. Charges created by any oversea company or company registered in Scotland over its property in England and Wales will fall within the scheme.

1.36 Sales of receivables (defined so as to apply only to those receivables that are commonly the subject of factoring or discounting arrangements) will also be governed by the scheme. Sales of receivables will be registrable.[44] Priority over receivables will be determined by the date of filing, rather than the date on which account debtors are notified.[45] Provisions in a contract generating a receivable that purport to restrict its assignment will no longer be effective as against the assignee.[46]

1.37 The principal features of the scheme for financial collateral are:

(1) Registration will not be needed where the chargee has obtained 'possession or control' of the collateral (within the meaning of the Financial Collateral Arrangements (No 2) Regulations 2003),[47] or has 'control' of it as defined by the regulations we propose.[48]

(2) A chargee will have control of financial collateral if the company can no longer deal freely with the assets free of the charge.[49]

(3) A security which is perfected by control will have priority over one merely perfected by filing; priority between charges perfected by control will depend on the order in which control was obtained.[50]

[41] See paras 3.35-3.41.

[42] See paras 3.30-3.34.

[43] See paras 3.231-3.245.

[44] See paras 4.19-4.25.

[45] See paras 4.12-4.19.

[46] See paras 4.35-4.40.

[47] SI 2003 No 3226. It has not proved feasible to define 'possession or control' for the purposes of those regulations but the draft regulations give clear guidance as to when a chargee has sufficient 'control' that registration is not required.

[48] See para 5.68.

[49] See also para 5.68.

(4) Purchasers of securities or securities entitlements for value and without notice of existing security interests will not be affected by them.

ADVANTAGES OF THE SCHEME

1.38 The scheme we recommend will bring significant benefits.[51] There will be direct savings both to users (secured lenders, other parties dealing with companies who borrow and the companies themselves) and to Companies House.

1.39 There will be short-term costs but these should be slight. The main costs will arise from setting up an electronic system, which is widely supported and will produce demonstrable savings in a short period of time. The cost of the other changes is likely to be relatively low. It will be necessary to re-train staff, but training staff to use simpler procedures is unlikely to be difficult. The changes will mean that standard charge documents can be simplified but there will be no need to do so. Some clauses used hitherto will no longer be necessary and can be deleted when the document is next revised.

1.40 Other benefits will result from simplification and clarification of the law. They are less easy to quantify, but nonetheless real. If the law is simpler, clearer and more certain, and the documentation required for transactions is less complex, the costs to lenders and to borrowers will fall in the long term.

1.41 Some consultees expressed concern that changes to the law may result in damaging uncertainty. It is not possible to guarantee that a new scheme will generate no uncertainty at all. However, we have considered the question of certainty carefully in relation to each proposal. We believe the changes proposed will make the law on many points significantly more certain; and that, in the form in which they are now put forward, they do not pose significant new risks of uncertainty.

SCOTLAND

1.42 When we received our reference from the Department of Trade and Industry, the Scottish Law Commission was also asked to consider registration of company charges, but their terms of reference were more limited than our own. At the end of 2002 the Scottish Law Commission published a Discussion Paper,[52] in which it made provisional proposals which did not involve any form of 'notice-filing'. It published its report in 2004.[53]

[50] See paras 5.95-5.102.

[51] The costs and benefits are explored in more detail in Part 2.

[52] Discussion Paper on Registration of Rights in Security by Companies (2002), Discussion Paper No 121.

[53] Scottish Law Commission, Report on Registration of Rights in Security by Companies (September 2004), Scot Law Com No 197.

1.43 One reason for the difference in the terms of reference was that the law of security in Scotland is different from that in England and Wales.[54] Equally the approach of the Scottish Law Commission's report is different from ours. They recommend that there should no longer be a requirement to register any security created by a Scottish company with the Registrar of Companies.[55] However, in order to constitute a floating charge under Scots law, it should be necessary to register the text of the deed in a Register of Floating Charges.[56] Information about these and other forms of rights in security (which under Scots law generally require some form of publicity for their constitution) would also be available in the company's annual return supplemented by more up-to-date information which the company would have to supply on request.[57]

1.44 As we explain in Part 3,[58] if these changes are implemented then, whether or not our recommendations are also implemented, the current system of 'mutual recognition of registration' between the two jurisdictions will come to an end. The Scottish Law Commission report and our report fit together by both making the same assumption. This is that charges created by a company registered in Scotland over its assets located in England and Wales would be treated in the same way as charges created by a company registered outside Great Britain over its assets in England and Wales. Such charges would have to be registered if they are to be enforceable in the debtor's insolvency.[59] Thus charges created over assets in England and Wales that on the Scottish Law Commission's recommendations would cease to be registrable at Companies House in Edinburgh would become registrable in the Company Security Register that we propose. With a floating charge that covered assets on both sides of the border, it would it be necessary both to register the text of the deed in a Register of Floating Charges in Edinburgh (in relation to collateral in Scotland) and to file a financing statement (in relation to the collateral in England) in the Company Security Register.[60]

FURTHER WORK

1.45 There are three issues on which we intend to carry out further work. These are (1) the extension of the scheme to unincorporated businesses, sole traders and possibly consumers, and also to unregistered companies; (2) whether a scheme that applies to both companies and other debtors should include title-retention devices; and (3) whether there should be a statutory restatement of the law of security over personal property.

[54] A much fuller account of Scots law will be found in the Scottish Law Commission's Discussion Paper on Registration of Rights in Security by Companies, DP No 121.

[55] Scot Law Com No 197 above, para 7.13.

[56] *Ibid*, paras 7.1-7.3.

[57] *Ibid*, paras 7.15-7.18.

[58] See paras 3.273-3.277 and 3.282.

[59] See para 3.284.

[60] This would apply whether the company was registered in Scotland or in England and Wales.

Consumers, unincorporated businesses and unregistered companies

1.46 For most of this project we have concentrated on security interests created by registered companies. The Secretary of State for Trade and Industry also asked us to consider whether any new scheme for company charges should be extended to unincorporated businesses and individuals.[61]

1.47 Charges over the goods of unincorporated businesses and individuals, and also general assignments of their book debts, require registration under the 'Bills of Sale Acts'.[62] The Acts impose many formal requirements, including a requirement that many details about the charge be registered. The penalties for failing to abide by these rules may be severe: under the 1882 Act a single technical defect may render the bill void between the parties. This means that the charge cannot be enforced even if the borrower is solvent. As the Crowther Report commented in 1971, 'it is difficult to imagine any legislation possessing more technical pitfalls'.[63]

1.48 In the CP we asked consultees whether they agreed that the current law on the creation and registration of security interests by non-corporate debtors was complex, unworkable and in need of reform.[64] The vast majority (over 90%) of consultees who responded agreed with our assessment.

1.49 In the time available to us, we have only been able to make very general recommendations on the general principles to be applied to charges created by other debtors. We look first at charges created by individuals in their capacity as consumers, and secondly at charges created by non-corporate businesses, such as partnerships and sole traders. We then consider charges created by unregistered companies.

Consumers

1.50 At present, consumers routinely buy goods using hire purchase and other 'quasi-security' devices. It is common, for example, to finance the purchase of a car through a hire purchase agreement, which gives the lender the right to repossess the car on default. It is also possible for consumers to borrow on the security of their existing goods, but there are very significant legal obstacles. If a lender wishes to take a charge or mortgage over a consumer's existing goods, they must comply with the complex requirements laid down in the Bills of Sale Acts. Some of the restrictions imposed by those acts are valuable. For example, the requirement that all the consumer's property be listed in the documents prevents consumers from charging goods that they may acquire in the future and from creating a floating charge over their goods. In the CP we said that we thought these were important elements of consumer protection that should be

[61] See above, para 1.15.

[62] Principally the Bills of Sale Act 1878 (the '1878 Act') and the Bills of Sale Act (1878) Amendment Act 1882 (the '1882 Act'). The Bills of Sale Act 1890 and the Bills of Sale Act 1891 add minor provisions to these Acts. For further detail see CP Part VIII.

[63] Crowther Report on Consumer Credit, Cmnd 4596, para 4.2.11.

[64] Para 12.90.

maintained.[65] Consultees agreed. In contrast, the extreme technicality of the registration requirements and the severe sanction if a mistake is made seem hard to justify.

1.51 In some respects the legal obstacles to consumers using their goods as security may not be bad, since consumers who do so fall outside important consumer credit protection measures. Under the Consumer Credit Act 1974, where a debtor under a hire purchase or conditional sale agreement has paid more than a third of the price, the lender may not repossess the goods except by order of the court.[66] This does not apply to bills of sale. Instead, where a debtor defaults on a loan backed by a bill of sale, the lender may issue a default notice and then take possession of the goods without a court order.[67] These gaps in protection may be significant because, despite the difficulties, a good number of bills of sale are given by consumers each year.

1.52 In the CP we noted that few bills of sale were granted: in 2001, only 2,840 were registered, most with a single group that specialised in lending on the security of cars. Since 2001, however, the number of loans secured by registered bills of sale has grown dramatically. In the first six months of 2005 nearly 11,000 bills were registered, and it is likely over 20,000 will be registered by the end of 2005. Several new firms have entered this market, with consumer loans generally secured over cars. Such rapid growth strengthens the case for reforming this problematic area.

1.53 We consider that there is almost certainly a case for replacing the Bills of Sale Acts with a modern system of registration of security over consumer goods, probably modelled on the scheme we are recommending for company charges, but containing proper safeguards for consumers. It should probably include the kind of protection provided by the Consumer Credit Act 1974 for those who obtain goods on hire-purchase and the like. However we think that this reform can best be undertaken by others with greater expertise in the field of consumer credit law. We therefore recommend that the Department of Trade and Industry, who are already involved in an extensive review of consumer credit law, should examine the question of replacing the Bills of Sale Acts with a more efficient and effective scheme.

[65] CP 164 para 10.26.

[66] Section 90.

[67] The debtor who wishes for more time to pay must initiate court proceedings for a time order under s 129(1)(b)(i).

Unincorporated businesses

1.54 The Bills of Sale Acts also make it difficult for unincorporated businesses to create fixed charges over goods, and prevent them from creating floating charges. The law adds complexities to the way that unincorporated businesses may assign their receivables.[68] In the CP we described the current law as out-of-date, unfair and fettering the ability of unincorporated businesses to raise finance.[69] We provisionally proposed that the Bills of Sale Acts should be repealed. Instead the notice-filing system we outlined for companies should be extended to non-corporate business debtors. As we reported in the CR, this was widely supported by consultees.[70]

1.55 If the notice-filing system were extended to non-corporate business debtors, it would have three main consequences for them. First, they would be able to created fixed charges without complying with the technical requirements of the Bills of Sale Acts. Instead, charges would be registered on-line in a similar scheme to the one used for companies. Secondly, they would acquire the right to grant floating charges over existing and after-acquired business property. Thirdly, the present distinction between general and specific assignments of book debts would be removed. The general rule would be that both were registrable.

1.56 Consultees identified various practical problems which would need to be addressed if the company scheme were to be extended to unincorporated businesses:

(1) In the absence of an existing register of unincorporated businesses, it may be difficult to identify the debtor, whether the debtor is a sole trader or a partnership.

(2) It is difficult to reconcile the idea of a partnership granting a charge with the current legal position under which partnerships do not have legal personality.

(3) If the procedure for insolvent partnerships is to recognise the rights of floating charge-holders, it will require significant reform.

1.57 Our current view is that these practical problems are soluble, and that notice-filing could be extended to unincorporated businesses, but more work is needed to determine how best to deal with these problems and others. We will consider whether to return to the question of unincorporated business debtors when we know whether our proposals for companies are to be implemented.

[68] A 'general assignment' of existing or future book debts must be registered as a bill of sale, or it will be void against a trustee in bankruptcy: Insolvency Act 1986, s 344.

[69] CP 164 para 10.4. In this we followed the Crowther Report para 4 and Diamond Report para 18.1.8.

[70] See CR para 2.71.

Unregistered companies

1.58 In the CP we provisionally proposed that charges created by unregistered companies should be included within the scheme.[71] There was broad support from those who addressed this issue. In the CR we said that on further consideration it seemed to us that the main issue of principle was which bodies corporate should be included. Bodies corporate can take several forms, for example, those incorporated by Act of Parliament or by Royal Charter, or public benefit corporations such as NHS foundation trusts; these can be subject to their own specific rules. In the case of industrial and provident societies, for example, there are additional requirements to register charges with the Financial Services Authority.[72] We sought views on whether the scheme we provisionally propose should be limited to registered companies and Limited Liability Partnerships (LLPs), or should apply also to other corporate bodies; and if so, as to which corporate bodies should be included.[73]

1.59 We did not receive many responses on this question and we have not had time to take the matter any further. The draft regulations in this report are therefore applicable only to registered companies and LLPs. We will return to this question if and when we take up the issue of charges created by unincorporated debtors.

Title-retention devices

1.60 Our CR included, as many consultees had requested, a detailed scheme for the registration and priority of title-retention devices, such as finance leases, hire purchase, conditional sales and retention of title clauses. It included provisions for the registration of 'security interests' over vehicles, and possibly other items that have unique serial numbers, using the serial number. This would allow anyone contemplating buying the vehicle or taking security over it to search by the serial number. If the financing statement did not include the serial number a buyer would not be affected by the security interest unless they knew of it.[74]

1.61 The response to these proposals was mixed. Some academics and organisations with extensive experience in North America supported the inclusion of title-retention devices even in a companies-only scheme. Among practitioners and the finance industry in the UK, however, there was almost no support for including title-retention devices of any kind, or the scheme for registration of security interests over vehicles, in a companies-only scheme. The Finance and Leasing Association, which had informally suggested that they were interested in including title-retention, were in the end against doing so at this stage. Some respondents thought that title retention should never be included. Others, including some from the finance industry, thought that registration and priority of title-retention devices should be considered as part of overall review of questions of transfer of title, within a scheme that would apply to all debtors.

[71] CP 164 para 5.122.

[72] Industrial and Provident Societies Act 1967, s 1. We did not deal with this aspect in the CP.

[73] CR para 3.8.

[74] See CR para 3.263. A subsequent secured party would take free of security interests over vehicles that were part of the debtors' 'equipment': CR para 3.179.

1.62 There appear to be three critical issues. The first is whether there should be registration of title-retention devices so as to give 'public notice' to those dealing with a company that assets in its possession do not belong to it. Some argued strongly that there should be, because title-retention devices perform a similar economic function to charges; other said they were completely different because the supplier retained the title. Thus no clearly right answer emerged from the responses. The question is whether publicity should depend on the formal nature of the transaction or the underlying economic reality. The need to register also depends on the nature of the arrangements. There may be a stronger case, for example for requiring registration of a finance lease than for requiring it of a simple retention of title clause over materials supplied to a company. We think this merits further investigation.

1.63 The second issue of concern to consultees was that under the scheme proposed, the same remedies on default would have applied to title-retention devices as apply to charges. In particular, some consultees opposed the mandatory provision that after default, any surplus must be returned to the debtor.[75] Curiously, the opposition to this came principally from lawyers. The finance industry was less concerned. Representatives volunteered that they have no real interest in any surplus; that agreements sometimes provide for any surplus to be returned; and that, even where there is no such provision, financiers would normally hand it over to be distributed to other creditors, if asked to do so by the liquidator.[76] Thus again no clear answer emerged from consultation.

1.64 The third issue, and the one that has persuaded us that further work on title-retention is justified, is the need to protect buyers and subsequent lenders. The innocent person who buys an asset subject to a financing agreement or who takes a security interest over it will normally obtain no title.[77] In practice the danger is greatest with frequently traded assets such as vehicles, and here there is a well-established voluntary system (operated by HPI Ltd and Experian Ltd). However, a financing arrangement that has not been registered under these schemes will still be effective against the innocent purchaser. We aimed, in effect, to strengthen and widen the voluntary schemes by providing that any unregistered title-retention device would be invalid against an innocent purchaser.

[75] That is, if, after a default by the debtor, the creditor has re-possessed the collateral (or it has been sold by a receiver, etc) and when all that is due (capital, credit charges and costs) have been paid to the creditor there is a surplus, the surplus must go back to the debtor. This is currently the rule for charges but not for finance leases or hire-purchase agreements.

[76] They said that they would often have more than one finance lease with the same debtor and would reckon to set off any surplus on one against deficits on others (in other words, to consolidate). This would have been permissible under the scheme as we had drafted it, if the agreements concerned provided for it.

[77] Unless it is a conditional sale or the purchaser falls within the protection of Hire Purchase Act 1965, Part III (non-trade buyers of motor vehicles subject to Hire Purchase). This is not a major issue in the case of retention of title clauses, because innocent buyers will normally be protected by the Sale of Goods Act 1979, s 25.

1.65 Our scheme would only have applied to finance agreements made by companies. Many people expressed concern about treating company vehicles and other assets differently to others.[78] Some respondents (including HPI) thought the scheme might well be valuable as part of a rationalisation of the rules on when purchasers are protected, provided it applied to all financing arrangements and not just those made with companies.

1.66 Our Ninth Programme of Law Reform[79] includes a project on transfer of title by non-owners. When that project was proposed originally, its aim was to tidy up the rest of this area of law after the transfer of property subject to security interests (including title-retention devices) had been dealt with by the present project. We now recommend that the registration and priority of title-retention devices (including finance leases, hire purchase, conditional sales and retention of title clauses) should be re-considered as part of, or in the light of, that project.[80]

A statement of the law of security over personal property

1.67 The scheme proposed in the CR, like the North American and the New Zealand statutes, contained provisions setting out the law on the creation of security interests, the rights and duties of the parties to the security agreement, and the enforcement of security interests following default. These rules would have applied to all 'in substance' security interests,[81] whether they were traditional securities, such as charges or mortgages, or quasi-securities such as title-retention devices.[82]

[78] The Finance and Leasing Association was also concerned about the effect of making a mistake in typing the vehicle identification number, which has 17 digits. We do not think that this is an insuperable obstacle. Often the information will be in digital form or can be scanned from machine-readable documents, so that the risks would be low. HPI also offer data cleansing to pick up mistakes of this kind, and we envisage that their service would continue.

[79] Law Com No 293, HC 353, March 2005.

[80] One issue that we addressed in the CR (paras 2.111-2.119) was whether the proposals to include title-retention devices would mean a change in the tax treatment of leases etc. The Inland Revenue told us that their opinion was that our proposals 'could introduce uncertainties regarding 'ownership"', and that therefore it might be appropriate to take a precautionary approach and make special provision to ensure that the tax treatment of leases is not altered by our proposals. This aspect may need to form part of any future reconsideration of title-retention.

[81] See CR para 3.30 ff.

[82] The provisions relating to default and enforcement would not have applied to 'deemed' security interests (that is, sales of receivables, and leases for more than one year or commercial consignments which do not secure payment or performance of an obligation).

1.68 The proposed statement was based on the overseas models, but in substance its contents were similar to current English law. However it contained a small number of mandatory rules, in particular that before disposing of collateral for which there is no recognised market, the creditor should give 10 days' notice to the debtor and other interested parties. That is not part of current English law; we included it because it seemed to us to be a fair and sensible rule. The draft regulations also provided that the disposal must be made in a commercially reasonable manner. In substance this is close to current law, which requires a mortgagee to obtain the best price reasonably obtainable,[83] but the form of the rule is different.

1.69 The statement in general, and these two provisions in particular, were criticised heavily.[84] The main reason for proposing a restatement for companies only was to clarify which rules would apply to various types of quasi-security. If title-retention is not to be covered in the companies-only scheme, we see no pressing need to include the statement. We are therefore no longer proceeding with these proposals for the time being. If the further work on title-retention mentioned in the last section suggests that title-retention devices are to be included, then we will consider whether some provisions on the applicable remedies are needed.

1.70 Meanwhile some consultees argued that it would be valuable to have a statutory restatement of the current law of security over personal property that reproduced the existing law. It might include setting out the assets over which security can be taken and the nature of the security that may be taken.[85] The aim would be two-fold: to clarify English law for its users (particularly those from overseas, many of whom say they find English security law inaccessible and mysterious) and to provide a model for European and international harmonisation. We intend to carry out a scoping study to see how much support there would be for a statutory restatement of this kind.

PLAN OF THIS REPORT

1.71 Part 2 sets out the business case for reform. Part 3 describes our detailed recommendations for the scheme for charges over property in general. Part 4 discusses registration and priority of sales of receivables. Part 5 deals with financial collateral. Finally, Part 6 contains a list of recommendations.

1.72 If the Government decides to implement our recommendations, it is likely that it will do so by making regulations under powers to be taken in the forthcoming Company Law Reform Bill. Appendix A sets out the draft regulations that we recommend should be made, together with explanatory notes.[86]

[83] *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949.

[84] Some criticisms were based on an incomplete grasp of how the scheme was to operate. For example, some consultees seemed to believe that our proposals required that notice must be given before any step could be taken to enforce a security interest, and as requiring that everything done must be commercially reasonable. Neither is correct.

[85] It would not necessarily include retention of title.

[86] In the footnotes to this report we refer to the draft regulations in Appendix A of this Report as 'draft regs'. The draft regulations that were proposed in the CR are referred to as 'CR draft regs'.

1.73 A list of consultees is to be found in Appendix B.

ACKNOWLEDGEMENTS

1.74 Many of those who contributed to the earlier stages of this project were listed in the CR.[87] A number of them and many others have helped us to prepare this report. We are grateful to them all. We would like to give particular thanks to a number of individuals who have given us extraordinary assistance since the CR was published. They are Richard Calnan of Norton Rose, who chairs the working party of the Financial Law Committee of the City of London Law Society, and Mark Evans of Travers Smith and Geoffrey Yeowart of Lovells, who are members of that Committee; Peter Graham, who chaired the working party of the Company Law Committee of the Law Society; Graham McBain; Edward Wilde of Hammonds, Honorary Legal Adviser to the Factors and Discounters Association; Professor Philip Wood of Allen and Overy; and Professor Sir Roy Goode QC, Mrs Louise Gullifer and Professor Harry Sigman, who have acted as consultants. The contents of this report are, of course, our responsibility and ours alone.

[87] CR para 1.35.

PART 2
THE BUSINESS CASE

INTRODUCTION

2.1 We explained in Part 1 that many features of the scheme we recommend are widely supported. This is particularly the case with electronic filing. There is wide-spread recognition that the Registrar should no longer have to check the particulars submitted against the charge document or issue a conclusive certificate. Many consultees also agreed with the scheme for priority by date of filing. Even those who opposed the scheme based their objections not so much on opposition to the proposals themselves as on the argument that the system works adequately and no sufficient case has been made for changing it.

2.2 We agree that reform should not be undertaken for its own sake. The question is whether there is a 'business case' for the scheme that we are proposing. We firmly believe that there is. We consider first the registration and priority of company charges, and then sales of receivables.

THE SCHEME FOR COMPANY CHARGES

2.3 We outlined the principal features of the scheme we are recommending in Part 1.[1] In summary, the central elements of the scheme for company charges are:

(1) Electronic filing will replace the current paper-based system.

(2) It will only be necessary to submit brief particulars of the charge in a 'financing statement'. Registry staff will not check the information in the statement against the charge document, which will no longer be sent to the Registrar. Provided that the financing statement identifies the correct company as debtor, the charge will be validly registered in respect of the property listed in the particulars.

(3) The formal time-period for registering a charge will be removed. Instead, a charge may be filed before or at any time after the transaction (save during the 'run-up' to insolvency).[2]

(4) The priority of a charge will depend on the date of filing.

(5) Filing will be voluntary, in the commercial judgement of the secured party (though an unfiled charge would be ineffective against an administrator or liquidator). The present criminal sanction against companies that fail to register will be removed.

(6) The current list of charges that must be registered will be replaced by a provision that all charges are registrable unless specifically exempted.

[1] See paras 1.32-1.37.

[2] See Insolvency Act 1986, s 245.

(7) The position of floating charge-holders will be strengthened. First, the priority of the charge will depend on the date of filing, unless otherwise agreed. This means that floating charge-holders will no longer have to rely on negative pledge clauses to prevent borrowers from granting subsequent fixed charges or from selling their receivables. Secondly, property subject to a floating charge will not be liable to be seized by execution creditors. This will remove the need for automatic crystallisation clauses to protect the chargee's interest.

(8) The position of buyers will be clarified. Briefly, buyers will take free of an unregistered charge unless they know about it. They will take subject to a fixed charge that has been registered unless the chargee authorised the sale. Where collateral is subject to a registered floating charge, buyers will continue to take free of it when they buy goods in the ordinary of course of the seller's business.

(9) Registration will not be necessary for charges over 'financial collateral' provided the chargee has either 'possession or control' within the meaning of the Financial Collateral Arrangements (No 2) Regulations 2003,[3] or has 'control' of it as defined by the scheme. A charge where the chargee has obtained control will have priority over one where the chargee has not. Purchasers of securities or securities entitlements for value and without notice of existing security interests will not be affected by them.

2.4 The scheme will bring substantial benefits.[4] There will be direct savings both to users (secured lenders, other parties dealing with companies who borrow and the companies themselves) and to Companies House. Other benefits will result from simplification and clarification of the law. The principal costs consist of setting up an electronic system for registering company charges on-line and training staff. However, we explain below that the costs will be relatively low and should quickly be recouped.

Direct savings and costs

The current cost of registration

2.5 In 2003-04, Companies House registered 197,000 mortgage documents for England and Wales. In each case, the secured party or the company prepared particulars of the charge and posted or delivered them with the original charge document to Companies House. There the paper work was checked by staff and entered manually on the register. In many cases, the party registering also requested a certificate of registration, which was sent by post.

2.6 We believe that the current fees of £28 (for registration and a certificate) reflect the costs to Companies House, which is in turn passed on to debtors. The fee income received by Companies House for this in 2003-04 was £1.7 million.

[3] SI 2003 No 3226.

[4] Above, paras 1.38-1.41.

Submission of documents on-line

2.7 Even if the only change were to make it possible to complete the particulars of a charge on-line and send the charge document electronically, registration would be somewhat simpler and cheaper for secured lenders.[5] It might also be easier for Companies House were all documents to be received in an electronic format.[6] However, we think the savings to lenders and to Companies House would be small.

Submission of particulars only

2.8 In contrast, we believe that substantial savings would be made if Companies House staff are no longer required to check the particulars against the charge document and issue a conclusive certificate of registration. We understand that this requires a significant number of staff,[7] and even then there are concerns that Companies House staff are not always able to check the particulars thoroughly.[8] They might be able to do so were the fees increased to cover the cost of employing more staff, but it does not seem justifiable to increase the cost to protect lenders against the small risk of their, or their advisors', avoidable mistakes. Further, it seems wrong in principle that lenders who make mistakes should be protected but a party who relied on registered particulars that are inaccurate should be without a remedy.[9]

2.9 We are not able to give figures for either the cost of setting up the system, any re-training of Companies House staff that will be involved or the number of staff that will be required to work on charge registration were the new scheme to be in force. However, the evidence from the introduction of a wholly electronic scheme for registering security over personal property in New Zealand[10] is very

[5] It is difficult to separate out registration costs from general transaction costs. We have been told that transaction costs are usually hidden, and that lawyers do not separate them out.

[6] As Companies House fees include the cost of checking the particulars, it is not easy to say how much is attributable simply to Registry staff having to deal with paper rather than electronic documents.

[7] We understand that some 32 staff are employed in the mortgage section.

[8] See CP 164 para 3.16. Our informal discussions with staff at Companies House suggested that they had a number of concerns. One was that the production of certificates takes a great deal of work and time. The certificates are produced overnight. Staff have to marry up the deed with the certificate and ensure it is sent to the correct address. Although they are used to handling this problem, if something goes wrong it can cause considerable difficulties. Another was the quality of information relating to mortgage charges. They said that mortgage charges are often difficult for the staff to fully grasp. They have to précis the information from Form 395. This sometimes leads to problems with the mortgagor or their solicitors, who may consider that the staff have not captured the essence of the charge properly.

[9] It is not clear whether a party who had been misled by incorrect particulars might have a remedy against the Registrar: see CP 164 para 4.216.

[10] Implementing the New Zealand PPSA 1999 (as amended).

encouraging.[11] In 2003-2004 over 465,000 financing statements were registered on the Personal Property Security Register.[12] The Registry currently has the full-time equivalent of five staff (including business service advisors who provide promotion and training), plus some part-time computer support. We understand that the charges for registering and searching reflect the real costs of the system. The fee for registering a security interest was initially a mere NZ$5 (about £2), and $3 to search. This fee resulted in an income that enabled the set-up costs to be recovered in around 7 months, and it has since been reduced to NZ$3 to register and NZ$1 to search. This suggests that were the scheme we recommend to be introduced, there would be significant reductions in public expenditure and the fees for registration.

2.10 Lenders will also find their costs reduced. There will be no need to submit the charge document, and the financing statement will be easy to complete. We anticipate that it will normally be unnecessary to employ staff with legal expertise to register charges.

2.11 The only serious difficulty that consultees raised was that, while there was support for allowing the particulars in the 'financing statement' to be brief in order to simplify filing, lenders' staff might find it hard to produce the 'brief description of the collateral' that the CR proposed should be required.[13] We now intend that lenders will be given a choice. They will be able either provide to a short description of the collateral (for example, 'all present and after-acquired property' or 'the equipment in the plant at X') or to copy the full description in the charge document directly from that document into the financing statement.[14]

2.12 The changes to the registration procedures will have direct costs in the form of some re-training of staff, but the experience of the New Zealand scheme suggests that training staff is not difficult.[15] Training staff to use simpler procedures is unlikely to be difficult.

2.13 We conclude that a system that allows on-line registration without human intervention is the only plausible way forward.

[11] The first project manager for the New Zealand registry, Andrew Bridgman, indicated that the costs to government of introducing the NZPPSR came to just over US$1.2 million. Software development costs amounted to US$846,800, with other costs (dedicated staff, hardware, publicity, travel, internal training and 'miscellaneous') adding an additional US$234,000. With quality assurance and consultancy costs, the total was US$1,1803,00. He also indicated that the system paid for itself from fee income in the first few months: total net revenue for the transitional period of 1 May - 31 October 2002 was US$1.6 million. Mr Bridgman noted that the costs were substantially reduced because: (a) development of the system was built off the back of an existing IT platform; (b) a trusted IT developer was used with low overheads and previous familiarity with government IT development, and (c) the development team used existing staff from high performing units within the Ministry. We do not know whether there would be equivalent factors here.

[12] The New Zealand scheme covers to title-retention devices and applies to individuals and unincorporated businesses as well as companies.

[13] CR paras 3.124-3.125.

[14] Assuming that the charge document is in electronic format. If it is not, the relevant clauses could of course be scanned and then copied over into the financing statement.

[15] Re-training costs are likely to be low because the information is principally a sub-set of that required for Form 395.

Facilitating the development of electronic conveyancing

2.14 The procedures for taking security over land will be simpler and quicker for both lenders and Companies House, since there will be no need to register charges over registered land at Companies House if they are registered at the Land Registry. The saving in cost from this will not be major. What is much more important is that the changes will assist the Land Registry in developing electronic conveyancing. They tell us that the current law is causing difficulties for this important project.

Removing the time-limit for registration

2.15 Removing the time limit for filing will also save significant costs each year. At present, Companies House rejects around 3000 applications because they are received outside the 21-day time period. The lender in these circumstances has two options. It may ask the debtor to re-execute the documents. This causes inconvenience, annoyance and the cost of repeating the submission of paperwork. Alternatively, the lender must apply to court to register out of time, an operation which must result in a costs bill for the applicant of at least several hundred pounds, and which we are told by Companies House is also time consuming (and thus presumably costly) for them. Allowing the secured party to file at any time (at the risk meanwhile of loss of priority or of the unregistered charge being ineffective in insolvency)[16] will save these sums.

2.16 This change will not have direct costs, nor will it affect other secured parties or purchasers, who will not be affected by an unregistered charge. We believe that the impact on unsecured creditors will be slight: they are already vulnerable to charges created after they have decided to advance credit.[17]

Improved searching

2.17 At present, the required particulars of registration and charge documents have to be sent to Companies House within 21 days of creation. It takes up to five working days from receipt of the documents for the charges to appear on the public register. This results in the risk of a 'period of invisibility' of up to 28 days (including weekends) before a charge appears on the register. During this time the charge is valid, and may take priority over charges created subsequently. Yet a potential secured party affected by the charge will not find out about it. Under the proposed scheme, priority will date from registration. As charges that have been registered will appear on the system instantaneously, there will be no 'periods of invisibility'[18] when a potential secured party may be affected by a valid charge that has yet to be registered. Searching will be simple and more reliable, and lenders will not have to wait before advancing funds.

[16] Or being vulnerable because it was registered only in the run-up to insolvency.

[17] See further below, para 3.80.

[18] Under the new scheme there may be short periods before charges over goods recently brought into the jurisdiction by an oversea company: see para 3.270.

Increased information

2.18 There will be public notice of charges over certain important types of asset not currently on the list of charges that must be registered.[19] This will help secured parties and others concerned to discover the company's financial condition.

2.19 Some consultees were concerned that less information would be provided on the new register than is currently available from Companies House, and this would increase the cost of searching. They were worried about our original proposal that charges over assets for which there is a specialist mortgage register should no longer have to be registered at Companies House.[20] We have now revised our recommendations. Charges over registered land will not require registration in the Company Security Register if they are registered at the Land Registry, but information about the charges will be forwarded by the Land Registry to Companies House and will be available to searchers.[21] Charges over other assets will remain registrable in the Company Security Register.[22] Thus there will be no effective loss of information about company charges currently registrable at Companies House.

Indirect benefits and costs

Simplicity

2.20 The rules we recommend for both registration and priority are both simpler than the current law. In the long term that will reduce the cost of training staff, of creating charges and resolving disputes.

Increasing confidence

2.21 Determining priority by date of filing will mean that once the chargee has filed a financing statement, it can be confident that its security will have priority over any other charge for which a filing has not yet been made.[23] Similarly, someone who has bought assets that are charged from the company will no longer be affected by the charge if it has not been registered. There will be a corresponding loss to charge-holders but it can arise only if, by accident or design, they have omitted to file.

Removing clauses with uncertain effect

2.22 The negative pledge and automatic crystallisation clauses that are frequently included in floating charge agreements (and which are unreliable in their effects) will no longer be required. Any waiver of priority by a secured party (chargee or pledgee) will depend on its agreement. There will be a corresponding loss to a

[19] Eg, charges over computer software and film negative rights; see CP 164 para 3.13. We do not recommend that existing charges that do not currently require registration should have to be registered. Responses to the CR indicate that most would prefer the risk that these will remain invisible to the burden of identifying and registering them within a transitional period. See para 3.290.

[20] See CR paras 2.51 and 3.289-3.342.

[21] See further below, para 3.38.

[22] See further below, paras 3.38(3) and 3.41.

[23] Save in those cases in which there is specific provision to the contrary, e.g. with a subsequent charge over investment property that is perfected by 'control', see Part 5.

subsequent secured party who might have been able to prove that it took without notice of a negative pledge clause and thus took priority over an earlier floating charge. However, as intending chargees normally conduct thorough inquiries, this loss seems minimal. Unsecured creditors may find it harder to execute judgment against a company subject to a floating charge. However, we were told they rarely find this to be possible because there will normally be an automatic crystallisation clause. In any event they have a powerful alternative, where the debt amounts to more than £750, of threatening insolvency proceedings.

Increasing certainty

2.23 Many of the points already mentioned will bring increased certainty to the law. In addition, replacement of the current list of charges that must be registered by a provision that any charge is registrable unless specifically exempted will reduce uncertainty as to what charges must be registered.[24]

2.24 The present rules governing when buyers take free of a charge are complex and uncertain. Whether a buyer takes subject to a fixed charge depends on whether the charge was legal or equitable, and whether the buyer will be put on notice of the charge merely because it was registered.[25] Under our scheme, these rules will be simplified and clarified. Buyers will not be subject to unregistered fixed charges, but will be subject to registered ones.

2.25 It would be unwise to claim that the introduction of a new scheme will not cause any uncertainty over points which currently do not arise or which are settled. What we can say is that we have considered possible uncertainty at every turn and that we are not aware of any area in which the scheme for charges remains significantly uncertain. Overall we are convinced that it will reduce uncertainty.[26]

Supporting financial markets

2.26 Our recommendations on financial collateral will provide additional clarity on when charges over financial collateral need to be registered, the priority of competing charges and when an innocent purchaser will take free of a charge. They are designed to ensure that financial collateral is freely transferable. For example, a secured party or other purchaser will be able to take simple steps to ensure that it has priority over, or takes free of, an existing charge of which it does not know without the need for searching. Equally a chargee will be able to protect its own interests by taking simple, clearly defined steps.

[24] Eg, there has been litigation over the meaning of 'book debts': see CP 164 para 3.14.

[25] See CP 164 paras 2.58-2.61.

[26] In this context we were interested to read the comments of the Financial Markets Law Committee. The Committee is particularly concerned with issues of legal uncertainty that may affect financial markets. The Working Group did identify some potential problems, but most of the issues raised in the Committee's response related either to the extension of the scheme to 'quasi-securities' in general or to the statement of rights and remedies. These no longer form part of our recommendations for the company charges scheme. The principal remaining issues relate to the definition of receivables. This is not part of the core scheme. We deal with the issues below, see paras 4.15. and 4.32 The Committee made it clear that they expressed no view on policy issues, and that silence on a point should not be taken as either assent or disapproval of our proposals.

2.27 We received strong support for our proposal to provide rules for charges over financial collateral, particularly from specialists in the field. We have refined our proposals in the light on the detailed responses received. The reforms will improve certainty and transferability in the financial markets.

Deregulation

2.28 The scheme that we recommend means that it would no longer be a criminal offence for a company and its officers to fail to comply with the requirements of the registration scheme.[27] This sanction is seldom applied in any event. The commercial consequences of failure to register – loss of priority and invalidity against the administrator or liquidator – are sufficiently important to ensure compliance. The removal of an unnecessary and rarely used criminal offence is a benefit in itself.

2.29 Companies will also be relieved of the responsibility to maintain their own registers of charges, though we understand that this obligation is frequently not complied with.[28]

EU developments

2.30 The EU is already showing interest in harmonising the law of personal property security interests across the Member States. There are frequent references to this in the European Commission's Action Plan on Contract Law;[29] and we understand that the Commission has commissioned a preliminary study of the differences between the laws of the Member States. There is enormous disparity in these laws of the Member States and it is frequently said that the differences constitute a real hindrance to the operation of the internal market. Any moves towards this form of 'sectoral harmonisation' will almost certainly involve establishing a public register and rules on the order of priority. Any EU directive or regulation is likely to involve priority by date of registration, since this is the scheme followed by the widely-cited EBRD model law.[30]

2.31 Some view the prospect of EU intervention as a reason for deferring any change to our law. We take a different view, as do many of those we consulted. We should not wait to do anything until we are compelled to. It would be better to have already developed a modern law that is flexible and efficient. This can then be put forward as a model for adoption by the EU, just as existing Directives have frequently been constructed on the basis of an existing national system.[31]

Conclusion on the scheme for company charges

2.32 Overall, there is a good business case for the changes that we propose both for registration of company charges and on their priority. The lower costs of the

[27] Companies Act 1985, s 399.

[28] See below, paras 3.298-3.300.

[29] *Action Plan on a More Coherent European Contract Law* COM (2003) final, OJ C 63/1, para 63.

[30] It is certainly unlikely that the EU will adopt a model that depends upon the distinction between legal and equitable interests!

[31] A prime example is the Directive on Unfair Terms in Consumer Contracts (93/13/EEC of 5 April 1993, OJ L 95/29), which is closely modelled on the German legislation.

scheme to the lender, and its greater certainty and reliability, will make it easier for companies to obtain secured credit and reduce its cost.

Enabling further developments

2.33 The other reason for adopting the proposed notice filing scheme for company charges is that this would be more readily compatible with what is required for sales of receivables, which we propose should be brought within the scheme.[32] We now turn to the case for this extension to sales of receivables.

SALES OF RECEIVABLES

2.34 In Part 4 we explain that the responses to CP 164 and the CR supported bringing sales of receivables within the scheme of registration and priorities, even among some who were opposed to extending the scheme to 'quasi-securities' in general. The trade body for the factoring and discounting industry, the Factors and Discounters Association, has consistently supported dealing with sales of receivables. We are firmly of the view that the priority rules relating to sales of receivables need to be modernised, so that priority will normally be governed by the date of filing. On balance, our view is that registration of sales of receivables should be required not only in order to preserve priority but also as a condition of the validity of the sale as against an administrator or liquidator.

2.35 There was also strong support from the industry for the proposal to include a provision that a prohibition on assignment of an account should be of no effect against the assignee. Others, particularly in the legal profession, were opposed. Many of the opponents were concerned that the change might have unintended effects outside receivables financing. In Part 4 we recommend that this proposal should be carried forward but with a more closely-limited scope of application.[33]

2.36 The principal reason for our recommendations on priority of sales of receivables and on prohibitions on assignment is that there is a strong business case for each of them.

2.37 Changing the rule of priority of assignments of debts to one of priority by date of filing is widely seen as advantageous. It will mean that once receivable financiers have filed they will ensure their own priority, without having to notify account debtors who owe the receivables. Notifying debtors is expensive. It is often not commercially desirable and sometimes it is not feasible.

2.38 Similarly, receivables financiers think it important that prohibitions on assignment of a receivable should no longer be effective against the assignee. We are told that the current rule causes serious difficulty in bulk receivables financing, when it is simply not feasible to find out whether particular receivables contain an anti-

[32] See para 1.36.

[33] See para 4.29.

assignment provision.[34] This provision should be restricted to the relevant types of receivables,[35] but we think it would be a valuable improvement to the law.

2.39 The business case for making sales of a company's receivables registrable is less obvious but it is nonetheless real. The extension would be of particular benefit to receivables financiers in terms of visibility and priority. Though they would have to file when they buy or take a charge over a company's receivables, they will have a ready way of discovering any existing charge or sale of the receivables that has been filed, and can safely ignore any that has not. Specialists in receivables financing (such as the Factors and Discounters Association) see registration as worth the cost.[36] The cost will be low, particularly as it will be possible to file one financing statement that can cover any number of transactions between the same parties. Requiring that outright sales be registered would also provide unsecured creditors with valuable information about the company's finances.

[34] There are devices that can mitigate the problem, such as requiring the assignor to 'buy back' non-transferable receivables; but these will not offer adequate protection when the assignor (the company) is insolvent.

[35] The definition of 'receivable' (in the draft regs in the CR, referred to as an 'account') has been re-drafted in more precise terms: see para 4.29.

[36] Because of questions raised by consultees, we have made particular enquiries about whether the filing requirement would cause unacceptable costs, in particular loss of confidentiality, in relation to (1) 'confidential invoice discounting' and (2) securitisation. The answer we have received from specialists is that it would not cause a problem in either context. See further below, paras 4.19-4.22.

PART 3
THE CORE SCHEME FOR COMPANY SECURITY

INTRODUCTION

3.1 In this Part we set out in detail the scheme that we now recommend for the registration of company charges and the priority of company charges and pledges. We refer to it as the 'core' scheme to distinguish it from the provisions on sales of receivables that we recommend in Part 4 and the special provisions for charges over financial collateral, which are explained in Part 5. The draft regulations implementing our recommendations are in Appendix A, together with explanatory notes.[1]

3.2 This Part is divided into eight sections. We start by looking at (1) terminology, (2) the scope of the scheme and (3) the requirement to register. This is followed by (4) the details of filing and searching and (5) priority rules. The section on priority rules includes an explanation of our recommendation to retain the distinction between fixed and floating charges, at least for the time being. We then consider (6) territorial application and (7) transitional provisions. We conclude (8) by explaining why we are not recommending the adoption of a proposal that all charges (other than charges over financial collateral) should have to be evidenced in writing signed by the debtor.

TERMINOLOGY AND CONCEPTS

3.3 In drafting the regulations contained in Appendix A of this report we have tried to use terminology and concepts that are familiar. Thus the regulations refer to charges[2] and pledges,[3] and to the chargee or the pledgee, rather than to the terms 'security interests' and 'secured party'[4] used in the draft regulations in the CR.[5]

3.4 We have retained some terminology that was used in the earlier draft regulations where it is convenient and is already used widely. For example, we use 'collateral' to describe the property that is subject to a charge or pledge. The word

[1] In the footnotes to this report we refer to a draft regulation in Appendix A of this report as 'draft reg'. A draft regulation that was proposed in the CR is referred to as 'CR draft reg'.

[2] Like Companies Act 1985, s 396(4), draft reg 2(3) provides that '"charge" includes a mortgage'.

[3] In this report, and in the title of the draft regulations, the interests are referred to collectively as 'security'.

[4] We use these terms when referring to the provisional recommendations in the CR. On occasions in this report we use the phrase 'secured party' when we wish to refer to a person who may be a chargee or a pledgee.

[5] The draft regulations in the CR were intended to apply not only to charges and pledges but to a wide range of other devices that have a 'security function', as do Revised Article 9 of the Uniform Commercial Code (the 'UCC') and the Canadian and New Zealand Personal Property Security Acts (the 'PPSAs'). The terms used were drawn from those legislative schemes. In Part 4 we recommend that outright sales of receivables should also be brought within the scheme of registration and priority. In order to implement this, the draft regulations in this report refer to 'sales of receivables' and 'buyer of receivables'.

is already widely used in the context of 'financial collateral' and it is a convenient way to refer to the relevant property. The draft regulations refer to the company that creates the charge or pledge as the 'debtor'.

3.5 There are a few terms that are wholly new. The most obvious examples occur in relation to the new procedures for registration, where the draft regulations refer to 'filing' a 'financing statement' or an 'additional statement'. In respect of the core scheme however, the number of new terms is small. Most of the less familiar terms used in the regulations relate to financial collateral.[6]

3.6 The draft regulations in the CR used concepts such as 'attachment' and 'perfection' that were defined in a way that applied to all 'security interests'. As we explained in the CP,[7] some writers already use these concepts to explain English law; but it became clear from the responses that the concepts are unfamiliar to many consultees and were not always understood. Definitions would be essential. With the simplified scheme that we now recommend we have found it unnecessary to employ 'attachment'. 'Perfection' is used only occasionally, when it is desirable to have a single word to refer to any steps necessary to render a type of security effective in the debtor's insolvency.[8]

3.7 Because the new draft regulations refer simply to existing types of security – charges (including mortgages) and pledges – those forms of security are not defined. The core scheme deals only with the steps necessary (if any) to render them effective in the debtor's insolvency and with their priority.

SCOPE

Companies and LLPs

3.8 Like Part XII of Companies Act 1985, the scheme we recommend applies to charges[9] created by companies registered in England and Wales and by Limited Liability Partnerships.[10] (We deal with oversea companies and companies registered in Scotland below.)[11]

3.9 When we discussed this aspect of the scheme in the CR, some consultees were uncertain what it meant. They asked, for example, whether the scheme would apply if one party to a security agreement were a company but not another; or if a

[6] To try to help the reader coming to the draft regulations for the first time, terms are normally defined in the regulation in which they first appear. This is not done if it would make the regulation too long or complex; the definition will then be found in the general definitions regulation, draft reg 42 or, with terms that relate only to financial collateral, in draft reg 41. Draft reg 43 provides an index of where in the regulations any definition may be found.

[7] See CP 164 para 2.5.

[8] Eg, draft reg 21 (charges perfected under the law of other jurisdictions; 'perfection' for this purpose is defined in draft reg 21(6)).

[9] On the question of sales of receivables see below, Part 4.

[10] The Limited Liability Partnerships Regulations 2001, SI 2001 No 1090, apply various provisions of the Companies Act 1985, including the charge registration provisions, to LLPs.

[11] Paras 3.259-3.272 and 3.281-3.284.

charge were given to secure a third party's obligation and the third party were not a company. It is important to set out the position as clearly as possible.

3.10 The scheme applies to charges created by a company over its property. If a company charges its property,[12] the charge must be registered if it is to be effective in the event of the company's insolvency.[13] It does not matter whether the chargee is a company or not. Equally it is immaterial whether the charge secures the company's own obligations or those of a third party, and whether the third party is a company. Conversely, a charge given by an individual or unincorporated business to secure the debt of a company is not affected by the scheme proposed in this report.

3.11 The scheme deals more fully with questions of priority than does Part XII of the Companies Act 1985. Part XII merely renders a charge that is not 'registered' within the permitted period void against other creditors; and it does not deal with purchasers other than creditors. However, the rule that a charge that is not registered in time is void against other creditors applies whoever the other creditor is. The same is true of the rules of our scheme governing the priority of a charge or pledge as against other charges or pledges. Equally the rules of our scheme that govern the effect of a charge as against a buyer apply whether or not the buyer is a company.

3.12 **We recommend that the scheme should apply to security created by companies registered in England and Wales and by Limited Liability Partnerships.**[14]

Types of security subject to the scheme

3.13 The 'core' scheme[15] applies only to traditional types of security: mortgages, charges, and (to a limited extent) pledges and liens.[16] Pledges are within the scheme only to the extent that (1) in some cases in which the debtor has factual possession of the collateral they are treated as if they were charges[17] and (2) the scheme governs the relative priority of pledges and other competing interests over the same collateral.[18] Liens are within it for the purposes of priority only.

[12] Including property of which it is a trustee: see below, para 3.115.

[13] Unless the charge is exempt from registration, for example because it is a charge over registered land and has been registered at the Land Registry (see below, para 3.38), or is exempt under the special provisions for charges over financial collateral described in Part 5. See further below, para 3.78.

[14] See draft regs 2(1) and 45(1).

[15] See above, para 3.1.

[16] The extension to cover outright sales of receivables is considered in Part 4. Title-retention devices are now outside the scheme: see above, para 1.29.

[17] See below, paras 3.19-3.25.

[18] See below, para 3.157.

Mortgages and charges

3.14 Mortgages and charges[19] will have to be registered to be effective in the company's insolvency, subject to various exemptions. These are considered below.[20]

3.15 In both the CP[21] and CR[22] we proposed that the current list of registrable charges[23] should be replaced by a requirement to register any charge that is not specifically exempted. This was supported by a large majority of consultees.

3.16 **We recommend that any charge created by a company should be registrable unless specifically exempted.**[24]

Pledges

3.17 Pledges in general will not be subject to a registration requirement. A few respondents to the CP suggested that pledges should also be registrable, on the ground that lenders would not always check that a company had physical possession of the property. However, it is widely accepted that a creditor who has taken possession of the collateral should not have to register.

3.18 The draft regulations in the CR, like Article 9 of the UCC and the PPSAs, set out a complete scheme to cover all transactions that have a security purpose. It did not refer separately to pledges. Instead it provided that security interests over those types of collateral that can be pledged ('goods, instruments, negotiable documents of title and money') could be perfected by possession of the collateral by the secured party or its agent.[25] A separate regulation dealt with perfection of security interest over goods in the possession of a bailee.[26] With the simplified scheme we are recommending we do not see the need for provisions on 'perfection' of what are simply pledges.[27] Subject to the exceptions mentioned below, under current law a pledge is valid, and thus effective in the debtor's insolvency, only if the goods are in the possession of the creditor. The possession may be actual or constructive, as where a third party bailee has attorned to the creditor.

3.19 Under current law, there are two cases where there may be a pledge although the goods or other collateral are in the possession of the debtor. These are (1) where the debtor has attorned to the creditor and (2) where the pledgee has released the goods to the debtor under a trust receipt or similar arrangement.

[19] The draft regulations define 'charge' as including a mortgage: see draft reg 2(3); compare Companies Act 1985, s 396(4), noted above, para 3.3 n 2.

[20] In relation to land, see below, para 3.38; for other exemptions see below, paras 3.43-3.45 and Part 5 (Financial Collateral).

[21] CP 164 para 5.6.

[22] CR para 2.19.

[23] Companies Act 1985, s 396.

[24] See draft regs 4 and 20.

[25] CR draft reg 24.

[26] CR draft reg 25.

[27] We said earlier that we see no reason make pledges registrable: above, para 3.17.

ATTORNMENT BY THE DEBTOR

3.20 There is authority to the effect that a pledge may be created over goods that are in the possession of the debtor, if the debtor has attorned to the creditor by, for example, undertaking to the creditor to hold the goods to its order.[28] In the CP we pointed out that, currently, an attornment by the debtor (if in writing) would require registration as a bill of sale or under the Companies Act 1985, section 396(1)(c).[29] We said that such attornments should continue to be registrable under a notice-filing system. There was broad agreement with this, and with the provision in the draft regulations in the CR to the effect that a secured party would not have possession of collateral if it was in the possession of the debtor or the debtor's agent.[30] Under our revised scheme, it should be necessary to register a pledge which arises only because the debtor or the debtor's agent has attorned to the creditor as if it were a charge.

3.21 **We recommend that a pledge under which the debtor has possession of collateral and attorns to the pledgee should have to be registered as if it were a charge.**[31]

TRUST RECEIPTS

3.22 Trust receipts are arrangements under which a pledgee allows the pledgor to have the goods or documents of title for a limited purpose, such as for sale. The pledgor acts as the pledgee's agent in selling the goods and it holds the goods and any proceeds of sale on trust for the pledgee. Under current law they are regarded as a method of securing the continuance of the pledge rather than as an independent security device, and they are not registrable as company charges.[32] The arrangement will normally be of short duration and if so it does not seem to pose a great threat to third parties. It is unlikely to mislead other creditors into thinking the debtor owns the assets concerned outright. Nor is it likely to damage purchasers, as normally the debtor has authority to sell the goods or documents so that a purchaser will take free of the pledge.

3.23 However, other creditors might be misled were the arrangement to continue, as it constitutes a form of non-possessory security; and if the debtor were not given authority to sell, but (for example) only to re-package the goods, innocent third party buyers might also suffer. Therefore in the CP[33] and CR[34] we proposed that the pledge should remain perfected only if the debtor has possession of the goods or documents for less than 15 days. This should apply not only when the goods are handed over to the pledgee to sell but also when they are handed over

[28] See R Goode, *Commercial Law* (3rd ed, 2004) p 45.

[29] See CP 164 para 4.15 and, eg, *Halsbury's Laws* vol 4(1) para 621.

[30] CR draft reg 24(2).

[31] See draft reg 23.

[32] R Goode, *Commercial Law* (3rd ed 2004) p 1015. Where the documents relate to imported goods, there is a separate provision exempting them from being a bill of sale: see the Bills of Sale Act 1890, s 1. We see no reason to retain this exemption for the purposes of our scheme: see below, para 3.269 note 335.

[33] CP 164 para 4.16.

[34] See CR paras 3.108-3.112.

for the purpose of such things as processing with a view to sale or trans-shipping. A buyer who did not know of the security interest should take free of it.

3.24 Most consultees who responded on this point agreed that there should be a provision making this kind of arrangement registrable, and that an innocent buyer should be protected. There was disagreement, however, over the period after which registration should be required. Some wanted the security to be registrable immediately, others after only a much longer period such as 90 days. Even though it would only be necessary for a pledgee to file one financing statement for each debtor,[35] we think that it would be unnecessarily burdensome to make registration necessary immediately, because (as we explained above) we do not think the immediate risk to third parties is great. However we think that there might be a risk long before 90 days had passed. We think our original proposal (which is closely modelled on the PPSAs)[36] strikes a sensible balance.

3.25 **We recommend that if negotiable instruments or documents of title have been pledged, or goods are held by a third party bailee to the order of a pledgee, and the collateral is released into the possession of the debtor for limited purposes such as sale, the pledge (and the pledgee's interest in the proceeds) should be treated as a charge over the goods and their proceeds. The charge must be registered within 15 days unless the collateral is returned to the creditor's possession before that time.[37] A buyer who does not know of the pledge will take free of it**.[38]

Liens that arise by operation of law

3.26 In some cases a lien will arise by operation of law, that is, without an agreement between the parties. An example is a repairer's lien. These do not fall within Part XII of Companies Act 1985.[39] We see no need to require their registration. However the scheme deals with their priority as against other charges.[40]

3.27 **We recommend that liens that arise by operation of law should be subject to the scheme only for the purposes of priority.** [41]

Contractual liens

3.28 Generally a lien over goods that arises by operation of law typically allows the lienee to retain the goods only until payment of charges for work done on the goods and not until other sums owed by their owner have been paid. Any right to retain the goods against payment of other sums must be agreed. A contractual

[35] See below, para 3.91.

[36] Eg, SPPSA, s 26.

[37] See draft reg 22. The arrangement will be treated as having priority as from the date of the pledge: see draft reg 22(5).

[38] This follows from the general provision about buyers and unregistered charges, draft reg 28. See below, para 3.216.

[39] Section 395 applies only to charges that are 'created' by companies.

[40] See below, para 3.189.

[41] See draft reg 4(1)(a).

lien is also a form of security:[42] for instance, the goods must be released once the sums covered by the lien are paid. It differs from a pledge in that (1) the possession of the goods was not given with the (primary) purpose of securing payment and (2) the lienee has no power of sale.[43] Contractual liens should therefore be included within our scheme but, as the only question will be as to their priority as against other interests, they can be treated like pledges.

3.29 **We recommend that for the purpose of the scheme, pledges should include contractual liens**.[44]

The property subject to the scheme

Personal property and land

3.30 The scheme we now recommend will apply to charges over both personal property and land, as does Part XII of the Companies Act 1985. However, charges over land will have to be registered on the Companies Security Register only if they are not registered, or the subject of a notice, on the Land Register.

3.31 The scheme we provisionally recommended in the CR applied only to personal property. We recommended that charges over land should be exempt from the scheme, principally to avoid the need for dual registration. To meet the concern to have information about company charges available from a single source, the CR recommended that the Land Registry should forward information about registered charges to Companies House[45] for information purposes only (that is, this would not affect validity or priority).[46]

3.32 There was a general welcome for making it unnecessary to register at Companies House before a proper entry can be made in the Land Register, provided that there is no reduction in the information about charges available from the register at Companies House. Most consultees accept that forwarding of information will resolve this issue. The Land Registry also welcomed the CR proposals in general.[47] However, unlike the proposals in the CR, our final recommendations do not exclude all interests in land. This is principally because our assumptions about the number of charges over registered land that would not

[42] Re *Cosslett (Contractors) Ltd* [1998] Ch 495 at 508. See also R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 1-42.

[43] A contractual lien that confers a power of sale is liable to be re-characterised as a pledge: *Guddenah Municipal Council v New Zealand Loan & Mercantile Agency Co Ltd* [1963] NSWR 1229, although this might be said to depend upon the extreme width of the power of sale in that case; *Osborne Computer Corporation Pty Ltd v Airroad Distribution Pty Ltd* (1995)17 A.C.S.R. 614 (recharacterised as pledge, but said not to be a charge and therefore not included in legislation which referred merely to 'charge' (which was defined as including a mortgage).

[44] See draft reg 42.

[45] Land Registration Act 2002, s 121 contains provision for the Lord Chancellor to make rules about the transmission by the Land Registrar to the Registrar of Companies of applications under Part XII of the Companies Act 1985, or Part XXIII, Ch 3 (the corresponding provision for oversea companies).

[46] An alternative suggestion was that a search at Companies House should link through to the Land Register.

[47] They prefer 'forwarding of information' to the 'link' described in the previous note.

be registered at the Land Registry once electronic conveyancing is introduced have turned out to be incorrect. We have also changed our view on charges over unregistered land.

FIXED CHARGES OVER REGISTERED LAND

3.33 We had assumed that with the advent of e-conveyancing almost all charges over registered land, including equitable charges, would have to be notified to the Land Registry by means of a document in electronic form.[48] This would end the current practice of taking informal equitable mortgages or charges over a company's land without notifying the Land Registry, and relying simply on registration at Companies House.[49] Although we knew that some other mortgages and charges over land would not be notified to the Land Registry, we doubted whether there would be enough of them to worry about. We have now learned that the Land Registry has not yet decided how to deal with equitable mortgages and charges over registered land when e-conveyancing is introduced. It is possible that these will not need to be notified in order for them to valid as between the parties.[50] If so, there may be a significant number of mortgages and charges over land that would not be notified to the Land Registry and that would be invisible to third parties if they did not have to be registered at Companies House. We therefore now consider that only mortgages and charges over registered land that are registered or made the subject of a notice on the Land Register should be exempt from registration on the Company Security Register.[51] Information about such charges should be forwarded to the Company Security Register for information purposes only. Other fixed charges over registered land should be registered on the Company Security Register in the same way as charges over assets in general.[52]

FLOATING CHARGES OVER REGISTERED LAND

3.34 In practice, an equitable charge can be protected by registration under the Land Registration Act 2002 only in relation to land already owned by the company or land it has already contracted to buy. The Land Registry reports that it receives

[48] CR para 3.302. The Land Registration Act 2002 contains a provision enabling rules to be made to allow for electronic conveyancing. Under these rules the disposition of a registered estate or charge, or an interest which is the subject of a notice in the register (or a contract for such disposition) will only have effect if it is made by means of a document in electronic form and it is electronically communicated to the registrar: Land Registration Act 2002, s 93.

[49] See CR para 3.302.

[50] We should report that a number of consultees expressed considerable concern at the idea that all equitable charges should have to be notified to the Land Registry. Notification would remain necessary if the chargee wished to ensure that its priority was preserved.

[51] See draft reg 4(1)(f), which exempts fixed charges that are registered, or the subject of a notice, under the Land Registration Act 2002. This will include registered charges over rentcharges, legal subcharges and franchises. It will not include a charge over a beneficial interest in land that does not also charge the legal estate, since such a charge is not registrable on the Land Register.

[52] There will be nothing to prevent a chargee from registering a charge over land on the Company Security Register even if the charge is also registered or a notice is entered on the land register. The filing may not be of any effect but it will not be wrongful or expose the filing party to any liability. Thus a chargee can instruct its employees, 'when in doubt, file'. It will be possible for the company to require the removal of a filing that is unnecessary.

relatively few applications to note floating charges.[53] We suspect that nearly all floating charges over the company's land will be accompanied by a fixed charge and that in practice floating charges over land will have little practical importance. However, we think that if the scheme for registration of company charges is to apply to some charges over land in any event, then floating charges should remain registrable on the Company Security Register.

CHARGES OVER UNREGISTERED LAND

3.35 Our recommendation that charges registered on the Land Register should be exempt from registration on the Company Security Register depends on information about them being forwarded so as to be available for searchers. The Land Registry tell us that this would also be technically possible with charges registered on the Land Charges Register[54] and would provide an acceptable solution. However, given the small numbers involved, they question whether it would be worthwhile. We agree. We recommend that charges over unregistered land should be registrable on the Company Security Register whether or not they are registered on the Land Charges Register.

3.36 In practice lenders taking a legal charge over unregistered land may find it not worth filing a financing statement. A legal mortgage is an event that triggers registration of the title to the land.[55] Where first registration is compulsory, application for registration must be made within two months of the date of completion of the transaction concerned (although this period can be extended for good reason).[56] Thus within two months the charge will be registered on the Land Register and exempt from registration under our scheme.

3.37 The priority rules under the companies scheme will be modified to preserve the priority rules applying to land. These issues are considered in more detail below.[57]

3.38 **We recommend that**:

(1) Fixed charges over registered land should not have to be registered on the Company Security Register if they are registered or made the subject of a notice on the Land Register.

(2) Information about charges registered at the Land Registry should be forwarded to the Company Security Register and made available with other information about company charges.

[53] This is presumably to avoid difficulties if the land is subsequently sold or charged: we understand that where there is such a notice, the Registrar would not accept registration of a subsequent specific interest without written consent from the floating chargee, in case the floating charge contained a restrictive clause.

[54] The information required and recorded would have to be altered, for example to include the company number.

[55] Land Registration Act 2002, s 4(1)(g). This does not apply to all types of land, for example a charge over mineral rights held separately from the surface.

[56] Land Registration Act 2002, ss 6(4)-(5).

[57] See below, paras 3.236-3.245.

(3) Charges over unregistered land, and any floating charge affecting land, should be registrable on the Company Security Register whether or not they are registered on the Land Charges Register.[58]

Personal property for which there is a specialist mortgage register

3.39 In the CR we proposed to exclude from the scheme all charges over personal property such as registered aircraft, registered ships and the forms of intellectual property for which there is a specialist mortgage register.[59] The principal aim was to avoid the need for dual registration. There was serious concern at this. It was said that it would result in a significant reduction in the information available to those dealing with a company, as (1) charges over the assets concerned would not always be registered on the specialist register and (2) it is not always possible to search the relevant register by name of the company that owns the asset. Moreover it would become necessary to search the specialist register as well as the company charges register, which would add to the cost and trouble of searching. Put simply, it is convenient to have all information about a company's charges in one place.

3.40 The general opinion appears to be that the cost of double registration is worthwhile for the information and general peace of mind that it would bring. Therefore we now recommend that charges over personal property for which there is a specialist mortgage register (registered aircraft, registered ships and certain types of intellectual property) should be included in the scheme. Charges over these assets will thus be registrable in the normal way.[60] Below we recommend provisions to preserve the effect of any statutory provisions on the priority of such charges.[61]

3.41 **We recommend that charges over registered ships and aircraft, and over the forms of intellectual property for which there is a specialist mortgage register, should be registrable on the Company Security Register whether or not the charge is registered on the specialist register**.

Charges over property outside England and Wales

3.42 We consider how the scheme should apply to charges over property outside England and Wales in a separate section on territorial issues.[62]

Charges excluded from the scheme: Lloyd's trust deeds

3.43 In the CR we provisionally recommended that certain transactions should be partially or wholly exempt from the scheme. We have already considered charges over land and other charges registered in a specialist register. In the light of our

[58] See draft reg 4(1)(f).

[59] CR paras 3.312-3.342.

[60] We think that it should be considered whether at some point in the future it could be made possible for the specialist registers to forward information to the Company Security Register. An exemption like that we propose for charges over registered land could then be adopted.

[61] See below, para 3.235.

[62] See below, paras 3.246 ff.

revised recommendations for the scheme as a whole, only one other exemption remains relevant to the core scheme being considered in this Part.[63] This is for charges that arise under certain types of trusts that must be established by corporate members of Lloyd's. In the CP we explained that a corporate member of Lloyd's is obliged to enter into several categories of trust deed to ensure that funds are available to pay policy-holders. These are currently registrable as charges. Some categories, particularly the trust deeds that some overseas regulators require each syndicate to enter, generate very large numbers of registrations.[64] However most of the registrations serve little useful purpose, since persons dealing with corporate members of Lloyd's (who are not permitted to undertake any other business) will know the nature of the arrangements. We therefore suggested that it is unnecessary for the charge constituted by these trusts to be registrable.[65] This was supported Lloyd's and by consultees generally.

3.44 Under the regulations, the 'Lloyd's Deposit Trust Deed' or 'Lloyd's Security and Trust Deed' created by each corporate member will continue to be registrable. This will serve as a warning to all concerned that the company is a corporate member of Lloyd's and will probably have entered other trust deeds. Other trust deeds will cease to registrable. Charges other than trust deeds created by corporate members will need to be registered in the normal way.[66]

3.45 **We recommend that Lloyd's trust deeds other than a Lloyd's Deposit Trust Deed or a Lloyd's Security and Trust Deed should be exempt from the scheme**.[67]

Charges that will not require registration

Supporting obligations

3.46 It appears to be the current law that if a right to payment is guaranteed or supported by an indemnity or letter of credit, and the right is assigned, the assignee is entitled (unless the parties agree otherwise) to the benefit of the guarantee or indemnity, or to the proceeds of the letter of credit, without showing a separate assignment of the 'supporting obligation'.[68] In the CR we proposed that these supporting obligations would not need to be registered separately. Instead, where the main charge is registered, the charge over the supporting obligation would also be treated as registered. It would be granted the same priority as the main charge. This was supported by consultees.

[63] Other exemptions will be needed if, as we recommend in Part 4, the scheme is extended to apply to outright sales of receivables: see below, para 4.31.

[64] See CP 164 paras 5.75-5.86.

[65] CP 164 para 5.83.

[66] For example, there may be a gap in time between a syndicate paying out to insured parties who have suffered a loss and being reimbursed by a re-insurer. To maintain liquidity, managing agents may borrow from a bank and create a further charge to secure the loan - either a fixed charge over the receivables or a floating charge over the premium trust fund.

[67] See draft reg 4(1)(g) and the definitions in draft reg 42. We are grateful to Mr Julian Burling, Legal Counsel to Lloyd's, and his colleagues for helping us to devise an appropriate formulation for this exemption.

[68] R Goode, *Commercial Law* (3rd ed 2004) pp 645-646.

3.47 We no longer think it is necessary to make provision as to when a charge arises over a supporting obligation. However we think that the charge should not have to be registered separately from that over the principal obligation.[69]

3.48 **We recommend that special provisions should apply where a charge is taken over a receivable, a document of title, a negotiable instrument or investment property and the charge covers a right to the proceeds of a letter of credit or a guarantee or indemnity which supports the principal obligation. If the charge over the principal obligation has been registered, the charge over the 'supporting obligation' should not have to be registered.**[70]

Rights to the proceeds of collateral[71]

CURRENT LAW

Unauthorised dispositions when buyer takes subject to the charge

3.49 If the company sells property that is subject to a charge, and the sale is not authorised by the chargee, the buyer will take subject to the charge unless it protected by one of the exceptions to the principle that a person cannot transfer a better title than he has.[72] The chargee's rights are not affected and it can enforce its rights against the buyer.[73]

3.50 In addition, if the debtor purported to sell outright, so that it purports to sell the chargee's asset,[74] the chargee may claim the proceeds of sale.[75] However, the chargee may not be able to claim both the original property and the proceeds. The chargee may of course claim both if the charge covers the type of asset that comprise the proceeds as original collateral. Thus a fixed charge over the debtor's equipment and its book debts will obviously apply first to goods and then, when they are sold, to the book debts generated by the sale.[76] However, if

[69] As to its priority, see below, para 3.194.

[70] See draft regs 20(1)(b), 28(5)(a) and 29(3)(a). 'Supporting obligation' is defined in draft reg 42.

[71] The scheme also deals with the proceeds of goods that are pledged but have been released to the debtor under a 'trust receipt' or similar arrangement. See above, para 3.25.

[72] The issue of the unauthorised sale under which the purchaser took free arose in *Barclays Bank plc v Buhr* [2001] EWCA Civ 1223, [2001] All ER (D) 350 (Jul).

[73] Where the buyer is a company it follows that the company has acquired property that is subject to a charge; and Companies Act 1985, s 400 requires that the company send particulars of the charge, and a copy of the charge, for registration. However the only sanction is a fine for non-registration; the validity of the charge is not affected. It follows from the normal principle that a person cannot transfer a better title than he has, that the chargee will have priority over any competing claims under charges created by the buyer. See M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 88.1, note 102.

[74] If the sale was expressly subject to the charge, then all that is being sold is the debtor's equity of redemption and the secured party has no right to the proceeds of that: R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 1-59; *Barclays Bank plc v Buhr* [2001] EWCA Civ 1223, [2001] All ER (D) 350 (Jul), at [46].

[75] In this context proceeds includes proceeds of proceeds, so long as these remain traceable directly or indirectly to the sale.

[76] R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 1-66.

the charge does not cover the proceeds as a distinct category of asset, the chargee must opt between claiming the original asset and adopting the sale and claiming the proceeds.[77]

Authorised dispositions

3.51 If the sale was authorised, either because the charge was an uncrystallised floating charge or because the chargee had consented to the particular disposition, the chargee's only claim will be to the proceeds.

3.52 Again there is no difficulty if the charge covers the type of asset that comprise the proceeds as original collateral. In other cases it has been said that the security interest will 'extend to proceeds of an authorised disposition where it is effected on behalf of the creditor rather than for the debtor's own account'.[78] We think that the general principle is that the security interest will extend to the proceeds unless it is expressly or impliedly agreed that the debtor is free to use the proceeds for its own purposes. Thus if the charge were merely a floating charge over the debtor's stock in trade and nothing else, the court would infer that the charge did not cover the proceeds.[79]

Other cases where the original collateral is lost to the chargee

3.53 It appears that the chargee is also entitled to compensation paid on compulsory purchase[80] and to insurance payments, provided that the insurance was not merely on the debtor's own interest in the property.[81]

Fruits and income

3.54 It seems that while the debtor is in lawful possession of the property charged, it is entitled to the fruits derived from the property, such as the progeny of livestock.[82] With investment securities we understand market usage to be that the dividend

[77] *Ibid*, paras 1-62-1-63, and *Barclays Bank plc v Buhr* [2001] EWCA Civ 1223, [2001] All ER (D) 350 (Jul), at [49]. Goode argues that this cannot be altered by a provision in the charge that the chargee should be entitled to both the property and 'the proceeds'; proceeds are whatever results from the disposition and not a separate category of collateral. Before his election it is unclear whether the chargee has a mere equity, which would be lost to a bona fide purchaser for value of the proceeds without notice of the equity, or an equitable interest that would be effective against all but the bona fide purchaser of a legal estate.

[78] R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 1-59, who claims that this paragraph (in his 2nd ed) was approved by the CA in *Barclays Bank plc v Buhr* [2001] EWCA Civ 1223, [2001] All ER (D) 350 (Jul). In fact the CA left open the case of the authorised disposition, at [46].

[79] Cf the discussion of the proceeds of sale of goods subject to a retention of title ('RoT') clause, when the proceeds may be held for the supplier or the relationship between supplier and buyer may be purely that of debtor and creditor.

[80] Cf *Law Guarantee and Trust Society Ltd v Mitcham and Cheam Brewery Co Ltd* [1906] 2 Ch 99 (mortgagee entitled to compensation paid under Licensing Act but, as the mortgagors were not in default, they were entitled to interest on the sum).

[81] R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 1-61.

[82] See *Tucker v Farm & General Investment Trust Ltd* [1966] 2 QB 421 (farmer who had ewes on hire-purchase entitled to the lambs). It is not clear what the position is when goods are pledged: a dictum at 431 (Diplock LJ) suggest that the right to offspring goes with the right to possession, but whether that would be applied to the offspring of a pledged ewe is not certain.

income and other distributions should be for the debtor. Where the property is under the chargee's control there will often be contractual provisions to achieve this result.[83]

A new charge?

3.55 A tricky issue is whether any right to proceeds constitutes a new charge which arises when the property is sold or is a continuation of the existing charge. This would have implications for priority and possibly registration (if the description does not cover proceeds). We think Goode is correct to say that 'there are compelling reasons for treating the security interest as an indivisible and continuous security interest which moves from the original asset to the proceeds'.[84] In other words, under current law there is no need for a separate registration of rights over the proceeds, except when these arise only because the charge covers them expressly.

PROCEEDS UNDER THE NEW SCHEME

3.56 The draft regulations in the CR gave the secured party an automatic right to proceeds.[85] We think that under the reduced scheme we are now recommending, an automatic right to proceeds is not required.[86] In most cases in which the debtor disposes of collateral subject to a charge and the transferee takes free, current law will in fact reach the same result. This may be because the charge is a floating charge over a wide range of collateral and the proceeds will be within its terms. With a fixed charge it may happen because, when the charge-holder consented to the disposition, it was implied that the debtor was not acting on his own account but on the account of the chargee. The debtor will hold the proceeds for the chargee. We see no need to provide for an express right to the proceeds of an authorised disposition or one under which the buyer takes free for other reasons.

3.57 The CR scheme, like the UCC and PPSAs, contained an elaborate provision on when it would be necessary to file in order to perfect an interest over proceeds.[87] If rights to proceeds are to be limited to rights that arise under the existing law, we think it is necessary merely to ensure that a charge that is properly registered in respect of the original collateral is treated as registered also in respect of any proceeds to which the chargee is entitled. It should only be necessary to register a financing statement covering the proceeds when the chargee is entitled to them solely because they are a form of collateral that falls within the terms of the original charge.[88]

[83] R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 1-61.

[84] *Ibid*, para 1-64. There is a contrary dictum in *Barclays Bank plc v Buhr* but it does not seem that the point had been argued.

[85] CR draft reg 29; see CR paras 3.182-3.187.

[86] This was an advantage that held out to RoT suppliers (who currently are not entitled to the proceeds of sale unless they make special provision and, even if they do so, normally do not register a floating charge). Simple RoT clauses are no longer included in the scheme.

[87] CR draft reg 29.

[88] See above, para 3.52.

3.58 **We recommend that where a charge is duly registered in respect of the original collateral, any right to the proceeds of the collateral arising other than only as a result of the terms of a floating charge should also be treated as registered.**[89]

Property acquired subject to a charge

3.59 Where a company acquires property that is subject to a registrable charge, section 400 of the Companies Act 1985 requires the company to have the prescribed particulars of the charge delivered to the Registrar of Companies for registration within 21 days of acquisition. The particulars must be accompanied by a copy of any instrument by which the charge was created or is evidenced, certified in the prescribed manner to be a correct copy.[90] The consequences of failing to register are different from when the company created the charge. The company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine; but the charge is not void against a liquidator or administrator, nor against creditors of the company.[91]

3.60 In the CR we provisionally recommended that where collateral is disposed of by the debtor subject to the charge, the security interest should continue in the collateral.[92] In other words, if the chargee had registered its charge before the transfer, it would not be necessary to file a financing statement against the transferee. There would be no equivalent of section 400.

3.61 Consultees generally agreed. However one raised the question of property that a company acquires from an individual or unincorporated body, subject to a charge, for example, where a business incorporates and assets that are subject to a charge are transferred from the old unincorporated business to the new company. We have considered the question and think that in this case it is also unnecessary to require the chargee to register. In practice the issue will arise very rarely.

3.62 The most common situation will be where land is sold by the old business to the company. Assuming that the existing charge was registered in the Land Charges Register or the Land Register, or was protected by the deposit of title deeds, the transfer of ownership cannot be made without the agreement of the chargee, who would take a new charge against the new company and then register. With other assets for which there is a specialist register the same will normally be true. It is conceivable that goods that are subject to a registered bill of sale might be

[89] Draft reg 20(1)(c).

[90] Section 400(1) and (2).

[91] Nor does it matter that the property was acquired from another company and that the charge had not been registered by that company. Thus a creditor who makes inquiries and discovers from whom the acquiring company bought the property might not discover the existence of the charge by searching the register against the company from which it was acquired.

[92] CR para 3.183; CR draft reg 29.

transferred to the new company.[93] However, there are so few such charges that they do not merit special provision. The position will remain as at present: the charge will be valid but will not appear on the Company Security Register.

3.63 **We recommend that where a company acquires property from another company subject to a registered charge, or acquires property from an individual or unincorporated business subject to a valid charge, the charge should be effective in the insolvency of the acquiring company although no financing statement has been filed against that company.**[94]

Other situations in which no filing will be required

3.64 It is convenient to deal here with two other cases in which a chargee will not have to make a fresh filing.

CHANGES IN THE COMPANY NAME

3.65 The first is when a company changes its name. There should be no need to file a fresh financing statement in this case. For companies registered in Great Britain it should be possible for the registry to transfer the financing statements into the name of the new company. They can also ensure that anyone searching the register under the name of the old company will be warned of the change of name. With oversea companies that have not registered a place of business in Great Britain, that will presumably not be possible unless Companies House has been notified voluntarily of the change of name. However, we think it should be adequate if there is a warning that those searching against an oversea company should find out whether the company has changed its name. They should then search against all the relevant names.

3.66 **We recommend that there should be no need to file a fresh financing statement when a company changes its name.**[95]

TRANSFERS BY THE CHARGEE

3.67 The second is when a security is assigned by the chargee to a new chargee. Provided the security is a charge that has been registered, no new filing will be required. However the new chargee may wish to change the register to reflect its interest. This will mean that any notices about the charge (for example, if the debtor claims that the financing statement should be discharged because all the obligations under the charge have been satisfied)[96] will be sent to the new chargee. It should be possible to achieve this by filing an 'additional statement'.[97]

[93] A charge may also be possible over intellectual property rights. Under current law the company acquiring the property subject to the charge is required to register it but if it fails to do so there is no sanction of invalidity. We have not heard that this causes any problem in practice.

[94] The charge over the property acquired will also retain its priority as against a charge created by the acquiring company: see draft reg 27.

[95] See draft reg 9(3).

[96] See below, para 3.133.

[97] See below, para 3.132.

3.68 **We recommend that it should be possible to alter the financing statement to record the transfer of a charge from one party to another, but this should not be required in order to preserve the effectiveness of the charge.**[98]

THE REQUIREMENT TO REGISTER

Electronic on-line filing

3.69 In both the CP[99] and CR[100] we proposed that the current system by which particulars of a charge and the charge document must be sent to the Registrar of Companies for registration should be replaced by a scheme of electronic 'filing' on-line.

3.70 As we reported above,[101] there was overwhelming support for allowing the submission of documents to Companies House in electronic form. Although we have not thought it appropriate to include in the draft regulations requirements that the register and the communications referred to (such as the financing statement) be wholly electronic,[102] that is our firm recommendation.

3.71 **We recommend that there should be a Company Security Register[103] in electronic form and that the Registrar should make rules requiring information for registration to be submitted in an electronic form**.

Responsibility for registering

3.72 Under current law it is the company that is responsible for sending the particulars for registration, default being punishable by a fine.[104] In practice it is often the chargee who sends the documents, since it is the chargee whose interests are mainly at stake. In both the CP[105] and CR[106] we proposed that the obligation be removed from the company. Only one consultee disagreed.[107]

3.73 **We recommend that the duty on the company to send particulars of charges for registration be removed**.

[98] See draft reg 13.

[99] CP 164 para 4.34.

[100] CR para 2.68.

[101] Para 1.21.

[102] That is a matter more appropriately dealt with in Rules that the Registrar should be empowered to make.

[103] See draft reg 5. We use the term 'Company Security Register' rather than 'Register of Charges' because in Part 4 we recommend that sales of receivables should also be registrable.

[104] Companies Act 1985, s 399.

[105] See CP 164 paras 4.52-4.54.

[106] CR para 3.137.

[107] Deutsche Trust Co. Ltd argued that it was the debtor that benefited most from the provision of secured credit and should bear the administrative burden of filing, maintaining or discharging a financing statement.

The charge document and the certificate of registration

3.74 We also proposed in the CP and CR that to register a charge, it should be necessary only to file particulars of the charge in a simple, electronic 'financing statement'.[108] It should no longer be necessary to send the original charge document. The Registrar of Companies would no longer be responsible for checking the particulars that have been filed and would not issue a conclusive certificate of registration.[109] The charge would be validly registered in respect of property listed in the particulars, but not in respect of any that was omitted.[110]

3.75 A number of consultees were reluctant to see the abolition of the conclusive certificate of registration. There is no doubt that the certificate is convenient to lenders and their advisors because it means that the charge will be effective and enforceable according to the terms of the charge document even if the registered particulars are not correct. However, as we explained in Part 2, even most of those who expressed reluctance accepted that it is no longer justifiable for the Registrar of Companies to be responsible for checking the particulars of charges and issuing a certificate of registration. It requires a large staff who are, in effect, needed only to check against errors by the chargee or its advisers. Provided that it is made easy for the chargee to provide a correct description of the collateral, the responsibility for registering correctly should lie on the chargee. Below we explain our recommendations on the collateral description required for the financing statement.[111] We believe these should make it easy to prevent errors.[112]

3.76 **We recommend that the charge document should no longer be presented for registration, and that the Registrar should no longer check the accuracy of the particulars or issue a conclusive certificate of registration**.

The sanction for failing to register

3.77 Our provisional proposal in the CP was that there should be no criminal sanction on any party for failing to file.[113] The decision whether to file would be a

[108] On what should be included in this see below, para 3.198.

[109] The party who filed would receive a 'verification statement', showing the date and time of registration, and the debtor would receive a notice also: see further below, para 3.123.

[110] See CP164 Part 4; CR paras 2.24-2.29.

[111] See below, para 3.107-3.109.

[112] The CLLS FLC response to CP 164 argued that the charge itself should be available on-line to searchers. We do not favour this approach: (1) the requirement is not consistent with our legal tradition, under which registration is not a requirement for creation of a charge; (2) if the whole document had to be filed, there might be problems of confidentiality; (3) if only the 'terms' had to be filed, there would be scope for argument and mistakes over whether all 'the terms' had been submitted and thus whether the charge was validly registered. (Note the remarks of Lord Walker in *National Westminster Bank plc v Spectrum Plus Ltd* [2005] UKHL 41, [2005] 3 WLR 58, at [158] on the number of documents that may be relevant to the decision whether a charge is fixed or floating.)

[113] CP 164 para 12.12.

commercial one for the secured party. Consultees agreed almost unanimously.[114] Most agreed also that the consequences of failure to file (or perfect in some other way, for example by taking possession of the collateral) should be that the charge would be ineffective against an administrator or liquidator and as against execution creditors, and should be vulnerable to loss of priority against a subsequent secured creditor who files first.[115]

3.78 **We recommend that it should not be compulsory to register a charge but that an unregistered charge should be**:

(1) at risk of losing priority to one that is registered first; and

(2) ineffective against a liquidator or administrator on insolvency, and against execution creditors.[116]

Removal of the time-limit for registration and last-minute filing

3.79 Current law requires that particulars of the charge be sent for registration within 21 days of the creation of the charge. Late registration may be made, or an omission or misstatement rectified, with the court's permission.[117] Its order may be on such terms and conditions as seem to the court just and expedient.[118] A normal condition is that registration is without prejudice to the rights of parties acquired during the period between the date of creation and the date of its actual registration.[119]

Removal of the time-limit

3.80 In the CP[120] and CR[121] we proposed that there should be no time-limit for filing, though there should be amendments to the Insolvency Act 1986 to prevent 'last-

[114] Originally, the Company Law Review Steering Group had been concerned that the sanction of invalidity might constitute a disproportionate deprivation of a person's possessions, in contravention of Article 1 of Protocol 1 of the European Convention on Human Rights. In CP 164 we concluded that the sanction was not disproportionate (para 3.43). We have since been strengthened in this view by the House of Lords' decision in *Wilson v First County Trust Ltd* (No 2) [2003] UKHL 40, [2003] 3 WLR 568. (For further discussion, see CR para 2.7 and note 20).

[115] A few consultees to CP 164 argued that an unperfected SI should nonetheless be effective as against the unsecured creditors in the debtor's insolvency. This is the position under the NZPPSA but none of the other schemes. It is premised on the view that unsecured creditors never consult the register. We agree that unsecured creditors may seldom do this but we understand that the register of company charges is consulted by credit rating agencies and others on whose information unsecured creditors rely, so we do not recommend the New Zealand solution.

[116] See draft regs 20 and 24. We also recommend that an unregistered charge should be ineffective against a buyer who does not know of it : see below, para 3.216.

[117] Companies Act 1985, s 404(1). The court must be satisfied that the omission to register within the 21-day period was accidental, or due to inadvertence or to some other sufficient cause, or is not of a nature to prejudice the position of creditors or shareholders of the company, or that on other grounds it is just and equitable to grant relief.

[118] Companies Act 1985, s 404(2).

[119] See CP 164 para 2.77.

[120] CP 164 para 4.75.

[121] CR para 3.142.

minute filing' of floating charges in the run-up to insolvency.[122] This was supported by a majority of respondents to the CP. Among those who responded to the CR, removal of the time-limit was supported by some[123] and not by others.[124] The objection given was that if registration can be made at any time, the register would be less reliable as a source of information. We think this argument is misconceived. With 'priority by date of filing', other secured parties need not worry about unregistered charges.[125] The same is true of buyers.[126] Unsecured creditors could be affected by unregistered charges but under current law they are vulnerable to charges created at any time (except to floating charges created during the run-up to insolvency, which would remain the case).[127] Moreover, when the court permits late registration, there is no method of protecting unsecured creditors.[128]

3.81 The time-limit causes practical problems. Each year, Companies House rejects around 3,000 applications because they are submitted late. Usually, the debtor is asked to re-execute the documents, at some inconvenience. We do not think the arguments for retaining the time-limit outweigh this cost.

3.82 **We recommend that the time-limit for registration be removed**.[129]

'Last-minute filing'

3.83 Insolvency Act 1986, section 245 provides for the partial or entire avoidance of floating charges given in various situations. These include where the charge was given within the last two years to a 'connected person', or where the charge was given to anyone else within the last 12 months before insolvency, unless new value was given or the company was solvent at the time. In the CR we provisionally proposed that section 245 should be amended to apply to any security interest in favour of the persons mentioned in that section that is filed within the times stated before the onset of insolvency, save when new value is given or the company is not insolvent at the time, as provided in section 245(3) and (4).[130]

[122] See below, para 3.83.

[123] Eight consultees agreed, including APACS, LIBA, Lloyds TSB, COMBAR, and the International Underwriting Association.

[124] Including Clifford Chance, the CLLS FLC, DLA, Barclays Bank and Bank Leumi.

[125] See para 3.155 below.

[126] See para 3.216 below.

[127] See para 3.85 below.

[128] Several consultees who wished to retain the time-limit supported the introduction of an administrative procedure that would allow late registration without prejudice to any charges that have been registered in the meantime. (The Companies Act 1989 would have introduced this: see CP 164 para A.29). This would effectively permit the charge to be registered at any time and the only sanction against late registration (other than possible invalidity in the case of late filing in the run-up to insolvency) would be the cost of the procedure. There would be no additional protection for unsecured creditors. In substance, this would be similar to our proposal, which would also permit registration at any time, with the sanction of loss of priority.

[129] Subject to the provisions on last-minute filing about to be discussed.

[130] CR para 3.146.

3.84 There was general acceptance that such a change would be needed. In the light of our recommendation that the distinction between fixed and floating charges should be retained at least for the time being,[131] we see no reason to extend the scope of section 245 beyond floating charges. It will still need to be modified, however, to catch floating charges that may have been created earlier but that were only filed in the run-up to insolvency.

3.85 **We recommend that section 245 of the Insolvency Act 1986 be amended to apply to any floating charge in favour of the persons mentioned in that section that is created or filed within the times stated before the onset of insolvency, save when new value is given or the company is not insolvent at the time, as provided in section 245(3) and (4).**[132]

Advance filing or priority filing

3.86 The scheme proposed in the CP and CR would allow filing in advance of the creation of the charge. At present, it may only be registered after it has been created. Allowing filing in advance enables a party negotiating a charge to safeguard its position; and also to make a single filing for a number of charges between the same parties.

3.87 Some consultees explicitly supported this. Others would prefer that only actual charges should be registered, to prevent the register from being cluttered with filings that do not represent actual charges. A third group would prefer the compromise of a 'priority notice' scheme, as is available in some other registers. Here, notice would give priority to a charge created within, say, the next 21 days; if not taken up, the notice would expire automatically after that period.

3.88 We think that the system should permit at least the filing of priority notices. However we recommend advance filing. In Part 4 we recommend that outright sales of receivables be brought into the registration scheme. If filing had to be made separately for each sale, there would be difficulties. Receivables financing is often on a 'facilitative' basis: that is, the agreement is that the company may be entitled to decide which receivables to offer to a factor, and the factor may be entitled to decide which to accept. There is no sale or agreement to sell until a particular batch has been offered and accepted. It would be inconvenient were it not possible to register in advance of the sale and to cover all the sales that might be made under the agreement.[133]

3.89 The chief reasons against advance filing were fears that the register would become cluttered with unwanted filings that did not represent actual charges, and

[131] See above, para 1.23 and below, paras 3.158-3.175.

[132] See draft reg 45.

[133] There might also be scope for argument about whether particular transfers of receivables fell within the registered sale agreement or were made under a separate agreement. A further argument in favour of advance filing is that it would be important if the scheme were ever to be extended to title retention (see paras 1.60-1.66 above). It is common for title-retention suppliers such as finance companies to have repeat business with the same corporate customer. One filing at the beginning of the business relationship would be sufficient to cover all future supplies to the same customer. Were simple retention of title clauses over raw materials and inventory to be included, there would be large numbers of 'repeat transactions' and advance filing would be essential.

that 'false' filings might be made deliberately as a way of injuring the reputation of a company against which the filing was made. Neither argument can be dismissed out of hand. However, clutter has not proved to be a problem in other jurisdictions.[134] There have been some instances of 'malicious filing' in the United States, though those of which we have heard seem to have been against individuals.[135]

3.90 If there is a charge agreement, the chargee should be entitled to file. Otherwise we think that no financing statement should be made without the debtor's consent. The difficulty lies in enforcing this provision. It is not feasible to require the party filing to prove that the debtor has consented, since this would require (at a minimum) that the debtor authenticate a form of consent and that the Registrar somehow check the validity of the authentication. However, we think that it would be adequate to provide three safeguards. First, the party filing should be required to certify, by means of a check-box on the electronic financing statement, that the financing statement is in respect of an existing security agreement or the debtor has agreed to the filing in advance. This will act as a reminder. Secondly, a party who files when there is no charge agreement and the debtor has not consented to the filing should to be liable to the debtor for any loss caused, unless the party filing had a reasonable excuse.[136] Thirdly, there should be a penalty for knowingly making the statement falsely. We understand that the Companies Bill is likely to make it an offence knowingly to register false information.

3.91 **We recommend that it should be possible to file a financing statement before any security agreement has been made.**[137] **However**:

(1) The filing party should be required to state that the filing relates to an existing security agreement or the debtor has consented to filing in advance.[138]

(2) Parties who file when there is no security agreement and the debtor has not consented to the filing should be liable to the debtor for any loss caused, unless they had a reasonable excuse.[139]

(3) There should be a penalty for making the statement knowing that it is false.

Searching

3.92 We have recommended that the register should be electronic. Any person should be entitled to search it on-line on payment of the appropriate fee.[140] A proper

[134] See CR para 2.54.

[135] Typically political figures. As will be evident from the next paragraph, this is not a problem specifically linked to advance filing. It arises from the fact that it is not feasible for the Registrar to check that there is a charge in existence.

[136] For example he reasonably believed that the debtor had consented.

[137] Draft reg 6(1)(a).

[138] Draft reg 5(3).

[139] Draft reg 17(1).

[140] Draft reg 15.

search should reveal a financing statement as soon as it has been registered by the system, which will record the date and time and allocate a number to it.[141]

3.93 Searches will be by company name, company number or financing statement number. Below we explain that with oversea companies that have not registered a branch or place of business in Great Britain, so that Companies House cannot verify the name of the company, we envisage that it will be possible to request that the search include 'near misses, that is, companies with names close to the name by which the search was made.[142]

THE DETAILS OF FILING AND SEARCHING

3.94 We have already recommended that the Company Security Register should be in electronic form and that the Registrar should make rules requiring information for registration to be submitted in an electronic form.[143] In this section we consider in more detail how the system would work.

3.95 The CR included a detailed description of how filing would operate, and we are grateful for the many comments we received on this.[144] We pointed out that many of the details would be more appropriate for Rules made by the Registrar under the powers to be given in any Companies Bill. The Rules are likely to contain detail of the kind contained in the subordinate legislation of the overseas PPSA schemes. In any event, the precise nature of the filing system cannot be determined or provided for until the system is commissioned and the necessary software is created.[145]

3.96 In the paragraphs that follow, we outline the scheme and discuss consultees' views. Before we do so it may be helpful to describe the process for those filing via the internet[146] under the draft regulations and the Rules that we anticipate being made:

(1) Someone wishing to file a 'financing statement' to register a charge (in practice, the chargee) would first have to register as a 'user' with the registry, which would probably include registering a payment method (such as establishing a direct debit facility or entering credit card details) and providing an email address for communications from the Registrar. The user would then be given an identification number and password that

[141] Draft reg 7. On search criteria see below, para 3.141.

[142] See below, para 3.100.

[143] Above, para 3.71.

[144] See CR paras 3.113-3.181 and CR draft reg Part 4.

[145] CR para 3.115.

[146] The Registrar may wish to consider a slightly different system for volume users who need to file large numbers of financing statements, such as banks or (if our recommendations in Part 4 are accepted) factors. It might develop a system akin to the New Zealand Government's G2B ('Government to Business') system. This allows direct linkage between the user's data recording system and the personal property security register (PPSR), so that data on the user's files can be transmitted to the PPSR at a keystroke. Thus once a bank has entered details of the charge and the debtor onto its own system, it need not input the data a second time but can simply have the relevant information transferred direct to the PPSR.

could be used to gain access to the system for this and future filings. (This process would be all on-line.)

(2) In order to file a financing statement, the user would enter data onto a series of screens.[147] Once the information has been transmitted to and accepted by the system, a financing statement registration number would be generated by the system. The financing statement number would appear on the 'verification statement', which would be sent automatically to the chargee and (usually) to the debtor.

(3) In addition, a 'financing statement personal identification number (PIN)' and a 'debtor PIN' would be generated. The financing statement PIN would be sent to the chargee separately; it should be kept private by the chargee. It would be used by the chargee to access the system to make changes to the financing statement. Likewise the debtor PIN would be sent to the company identified as the debtor, to enable it to make changes to correct the financing statement under a procedure we will describe below**.**[148]

The financing statement

3.97 In the CR we provisionally recommended that the financing statement should contain

(1) the name of the debtor and its registered number (if any);

(2) the name and address of the secured party or its agent;

(3) a description of the collateral;

(4) whether the filing is to continue indefinitely or for a specified period; and

(5) such other matters as may be prescribed by the Rules.[149]

There was general agreement that the financing statement should contain this information.

3.98 **We recommend that the financing statement should contain**:

(1) the name of the debtor and its registered number (if any);

(2) the name and address of the chargee or its agent;

(3) a description of the collateral;

(4) whether the filing is to continue indefinitely or for a specified period; and

[147] It would also have to give a confirmation that a charge agreement exists or the debtor has consented to the filing, again probably by checking a box to that effect. See above, para 3.91.

[148] See para 3.137.

[149] See CR paras 3.118-3.134.

(5) such other matters as may be prescribed by the Rules.[150]

3.99 We consider below various further points about the content of the financing statement.

The name of the debtor and its registered number

3.100 In the CR we explained that it should be possible for the system to check automatically that the name and number entered match the number recorded for that company on their existing records. It is envisaged that unless both the name of the debtor and its registered number are given, and they match each other, the filing will not be accepted. This should go a long way to reducing the risk of making a mistake in recording the details of the debtor. Consultees regarded this as an important safeguard.

3.101 Below we recommend that the scheme should apply to charges created by companies incorporated outside Great Britain where the charge is over assets here, even though the company has not registered or does not have a place of business here.[151] Thus there will be instances where the debtor will not have a Companies House registration number. In such a case automatic checking of a name/number match will not be possible.[152]

3.102 Thus the party filing must either enter a matching name and number or confirm that the company is an oversea company that has not registered a branch or place of business in Great Britain.

3.103 **We recommend that a filing against a company registered in Great Britain, or that has a registered place of business or branch here, should not be accepted unless both the name and company number are given and they match**.

The name and address of the chargee or its agent

3.104 Most of those who commented on this issue agreed that the name and address of the chargee or its agent should be required. Some expressed concern that lenders to companies conducting controversial business, such as research on animals, may be subject to intimidation. Consultees thought that in such circumstances it would be important that the financing statement could show an agent's name rather than the chargee's own.

3.105 The financing statement will be effective even if the information relating to the chargee is wrong or out-of-date. The debtor can supply the information if need be. However, it is in the parties' interest to ensure these details are accurate, as requests for further information and any demands for changes to the financing

[150] See draft reg 6(2).

[151] See below, para 3.268.

[152] This has implications for the search tools that should be made available. See below, para 3.126.

statement are likely to be sent to the party shown as the chargee using the details recorded.[153]

3.106 **We recommend that it should be possible for the chargee to file in its own name or through an agent, so that only the name of the agent will appear on the financing statement**.[154]

A description of the collateral

3.107 In the CP we proposed that that the description should be 'brief'.[155] A large majority expressed agreement. In the CR, 'description' was not defined further in the draft regulations[156] but we recommended that the description should be brief, with a word limit on the amount of information that could be provided. This was to prevent the current practice of just 'cutting and pasting' large amounts of the charge document onto form 395.

3.108 In the light of discussions with consultees we now think that this policy was mistaken. It should still be possible for the chargee to use a brief description if it wishes to do so, even if the description is over-inclusive. The system might even be designed to allow the collateral to be described by checking one of a series of tick-boxes. (For example, there might be one for 'all present and after-acquired property' and others each referring to types of collateral which are commonly the subject of more charges with a more limited scope, such as 'proceeds of sale of goods supplied by the chargee'.)[157] If the debtor objects to an over-wide description, it may demand that the description be corrected to cover only what falls within the charge agreement, but the inaccuracy should not prevent the financing statement being effective to register the charge. However, we no longer think that the description should be required to be brief. The parties may prefer a precise description and it may be difficult to produce one that is both brief and accurate. We have been told that some US jurisdictions which have imposed a word-limit on collateral descriptions have found it causes difficulties. We now think that the chargee should be able to give a full description of the collateral. The safest way to do so may be to cut and paste the relevant clauses of the charge agreement into the financing statement. We think it should be possible to do this. It will add to the volume of any search results but this disadvantage is outweighed by the increased accuracy and reliability of the filing.

3.109 **We recommend that there be no word limit on the description of collateral in the financing statement**.[158]

[153] This will be particularly important where a secured party changes agent. As the Law Society Company Law Committee pointed out, when a lender changes lawyers, they will either need to change the agent listed on their filings, or ask the previous lawyers to direct enquirers to the new agents.

[154] See draft reg 6(2).

[155] CP 164 para 12.5(3).

[156] CR draft reg 47(7)(d).

[157] As we explained in CR para 3.128, we do not recommend that the 'collateral type' be a searchable field. See further below, para 3.140.

[158] See draft reg 6(2)(d).

Duration of the filing

3.110 In the CP we provisionally proposed that a filing should not necessarily be for a limited duration; it should be effective for the period indicated on the financing statement.[159] A large majority of consultees agreed that it should be possible to file for the security interest to last indefinitely; most considered it appropriate to permit filings for a fixed duration as an alternative. In the CR we provisionally recommended that a filing (unless discharged) should be effective either indefinitely or for such period as has been indicated on the financing statement.[160] This was generally accepted by those who commented. With the more limited scheme that we are now proposing, which will apply only to charges and sales of receivables, it is probable that almost all filings will be for an indefinite period.[161] Nonetheless we see no reason to prevent a creditor filing a financing statement to have effect for a limited period, and we confirm our recommendation. However, we accept the suggestion of Companies House that it would be more certain were the party filing required to state the date at which the financing statement should cease to have effect.

3.111 **We recommend that a filing (unless discharged) should be effective either indefinitely or until such date as is indicated on the financing statement**.[162]

Trustees

3.112 Either the debtor or the chargee may be a trustee. Where the debtor company is a trustee the registration of charges over trust property has given rise to difficulties. There is doubt whether such a charge is registrable under the Companies Act 1985, section 395, since that section applies only to 'a security on the company's property' and property held beneficially for another may not be 'the company's property'. The current practice of Companies House is to register a charge submitted by a trustee and to record on the register that the chargor is acting as a trustee. The responses to the Steering Group's consultation document pointed out that the position of commercial trustee companies under Part XII Chapter I of the Companies Act 1985 is unsatisfactory and should be clarified, but there was little agreement on the solution.

3.113 In the CP we provisionally proposed that a charge created by a trustee company over trust property should be registrable, since otherwise it might be difficult for those dealing with the property to discover that it was subject to a charge. We also proposed that the financing statement should disclose that the chargor is merely a trustee. This was supported by a large number of those who responded on the question. We confirm the first recommendation, but we now think that it is not necessary that the financing statement disclose that the property is held in trust. There is no general scheme for registration of the fact that a company holds property in trust rather than beneficially and it would be illogical to impose one in relation only to property that has been charged.

[159] CP 164 para 4.86.

[160] CR draft reg 49.

[161] Fixed duration filings are most appropriate for finance leases and the like, which are not now to be included in the scheme.

[162] See draft reg 6(2)(e).

3.114 We would point out that where a company charges its beneficial interest under a trust, that will be registrable against the beneficiary company in the normal way.

3.115 **We recommend that charges over property held by the debtor company in trust should be registrable in the same way as charges over property held beneficially**.

3.116 The chargee may also be acting as a trustee for a group of lenders. In this case the trustee can be entered as the 'chargee' on the financing statement. However, there will be a provision for the chargee to record that it is acting as a trustee if it wishes to do so.[163] This is because, as we will see, when a chargee is a trustee a different procedure applies if the debtor complains that the financing statement is inaccurate or should be discharged.[164]

3.117 **We recommend that the financing statement should permit the party filing to record that the chargee is a trustee for others**.[165]

Other matters

3.118 A few respondents to the CP argued that the amount secured, or the maximum amount, should have to be stated on the financing statement. Some thought that the financing statement should state whether a charge has actually been created. In the CR we rejected these suggestions.[166] The statement of the amount secured is not a useful piece of information since, unless the charge is for a fixed amount, it is most unlikely to be accurate by the time anyone searches the register.[167] To provide the date on which the charge was created is not possible in a system that has the advantage of allowing filing before the charge has been agreed or has attached, unless a second registration is to be required. Although some respondents argued that the date of creation may be useful, we do not think that the benefits of including this justify the costs of a second registration.

3.119 We do not envisage the system requiring any other information on the financing statement. However, it seems only sensible to include a power to prescribe other information by the Rules should experience show that it is needed.

3.120 **We recommend that the Registrar should have power to make Rules that may require further information on the financing statement**.[168]

Verification statement

3.121 In the CP we said that there should be a mechanism to ensure that the debtor is aware of the filing after it has been made.[169] A large majority of respondents

[163] Draft reg 6(3). Omitting this, or making a mistake in this field, will not prevent the financing statement being effective to register the charge.

[164] See below, para 3.137.

[165] See draft reg 6(3).

[166] See CR para 2.47.

[167] See CP 164 para 3.17.

[168] See draft reg 6(2)(f).

agreed. In the CR we provisionally recommended that, when a financing statement has been filed, the Registrar should have to send a verification statement to the party who had filed (typically the secured party). We did not think that the Registrar should be responsible for notifying the debtor; the debtor might be an oversea company of which Companies House has no record. Instead we suggested that the party who had filed should be obliged to send a copy of the statement to the debtor within 10 business days, unless the debtor had waived the right to receive a copy.

3.122 There was general agreement that the party who filed should receive a verification statement but there was concern over the proposal that the party who has filed should be responsible for notifying the debtor. By accident, or if the filing were a malicious one, the notice might never be sent to the debtor. On reflection we think this argument has weight. We think that it is proper to require the Registrar to send a notice to a debtor that is a registered company or that has registered a place of business, unless the debtor had waived the right to receive a copy. The requirement would be satisfied by the Registrar dispatching a notice by post to its registered address.[170] Where the company is not registered in Great Britain and has not registered a branch or place of business here, the party who files should be obliged to send a copy of the statement to the debtor within 10 business days, again unless the debtor had waived the right to receive a copy. The chargee who without a reasonable excuse omits to do this will be liable in damages for any loss caused to the company named as debtor.[171]

3.123 **We recommend that when a financing statement has been filed**:

(1) The Registrar should have to send a verification statement to the party who has filed, unless that party has waived the right to receive a verification statement.

(2) Where the debtor is a company that is registered in Great Britain or has registered a place of business or branch in Great Britain, the Registrar should be obliged to send a copy of the verification statement by post to its registered address (or by e-mail to any e-mail address registered for the company), unless the debtor has waived the right to receive a copy.

(3) Where the debtor is a company that is not registered in Great Britain and has not registered a place of business or branch in Great Britain, the Registrar should be obliged to send a verification statement to the party who has filed, and the latter should be obliged to send a copy of the statement to the debtor within 10

[169] CP 164 para 12.24(2). Some thought that this was unnecessary; the debtor should be aware that it has created a charge. With respect, this misses the point; the statement is needed as a safeguard against filings made against the wrong debtor or containing incorrect particulars (on which see further below, paras 3.133-3.137).

[170] At present Companies House does not record email addresses for registered companies. If they do so in the future, the verification statement could be sent to the company listed as debtor by e-mail.

[171] Draft reg 17(2).

business days, unless the debtor has waived the right to receive a copy.[172] **A chargee who fails to do this without reasonable excuse should be liable in damages to the company named as debtor.**[173]

Errors in the financing statement

3.124 As we explained earlier, under the system we recommend the party registering a charge will file only the financing statement. The charge document will no longer be sent, and the Registrar will no longer check the accuracy of the particulars or issue a conclusive certificate of registration. It follows that it will be up to the party filing – normally the chargee – to ensure that the particulars on the financing statement are correct.

3.125 The financing statement should contain the debtor's and the chargee's (or its agent's) details, the duration of the filing and a description of the collateral. The system will probably be configured so that the filing will be rejected unless each required field is completed. The filing will not be rejected because some of the information entered is incorrect. The effect will depend on the mistake that is made.

3.126 We have said that the system will check the name and number of registered companies and, we anticipate, will not accept a filing against a company registered in Great Britain unless both match. This should prevent mistakes about the debtor's identity, except where the filing identifies entirely the wrong company as debtor. Where the company is an oversea company that does not have a registered branch or place of business in Great Britain, cross-checking will not be possible. Then the effect of the filing will depend on the test set out in the draft regulations. The filing will be effective where a reasonable search, conducted in accordance with the requirements of the draft regulations and the Rules relating to searches,[174] would reveal the financing statement.[175]

3.127 In contrast, an error in the collateral description will result in the charge being ineffective in the debtor's insolvency, and at risk of loss of priority, in relation to collateral that was omitted. However, it will be effective as regards other collateral that is described in the financing statement.

3.128 An error in the duration of the financing statement will result in it being effective only for the period stated. (The system might be configured to send an electronic reminder to the party who filed shortly before any filing for a fixed period is due to

[172] See draft reg 8.

[173] Draft reg 17(2).

[174] On searching see below, para 3.141.

[175] We have said that with oversea companies that have not registered a branch or place of business in Great Britain, it is envisaged that those searching the register will be able to ask for 'near misses' (see above, para 3.93). A registered financing statement that gives an incorrect name will be effective to register the charge unless a search using the 'near miss' facility would not have revealed the financing statement.

expire, which would lessen the effect of any mistake in that field.) A mistake in the details of the chargee will not affect the effectiveness of the filing.[176]

3.129 If a mistake has been made, it may be corrected by means of a financing change statement. This may be done voluntarily by the party who filed or on the demand of the debtor. This is considered below.[177]

3.130 These features of the scheme were explained more fully in the CR. Although several consultees regretted the loss of a conclusive certificate, most of those who commented on the detail of the proposals accepted our approach.

3.131 **We recommend that**:

(1) The effectiveness of a filing should not be prejudiced by a defect, irregularity, omission or error in the financing statement unless it would have the result that a search that is conducted in a reasonable manner, in accordance with the requirements of the draft regulations and the Rules relating to searches, would not reveal the financing statement.

(2) An error in the collateral description should result in the charge being ineffective in the debtor's insolvency, and at risk of loss of priority, in relation to collateral that was omitted. However, it should be effective against other collateral described in the financing statement.[178]

Additional statements

Amendments by the chargee

3.132 From time to time it may be necessary to amend a financing statement, for example to show that a charge has been discharged or that collateral has been added to or released from the charge. This will be done by the chargee or its agent filing an additional statement. An additional statement may also be used to extend the registration of a financing statement that was for a limited period, or to enter a notice of transfer or subordination of the security. It is envisaged that the additional statement will be made by the party who filed using its PIN. If the registration is being extended or collateral added, the Rules will require the party filing to confirm that there is an agreement to the relevant effect or the debtor has consented.

Amendments by the debtor

3.133 The registration process is in effect managed by the party who files, the chargee or its agent, with little or no intervention from the Registrar. As a counter-balance, the debtor should have the right to demand that, for example, an overly broad description of the collateral be corrected. It should be entitled to demand that a financing statement is discharged when all the secured obligations relating to it

[176] See above, para 3.105. The Rules may require further information and prescribe the effect of a failure to give the required information or of an error in what is supplied.

[177] See paras 3.133 ff.

[178] See draft reg 9.

has been performed, or if a filing is made without the its consent where no security agreement exists, that the filing be removed. In the CR we recommended that the debtor (or any other person with an interest in the property) should be able to obtain the correction or removal of a financing statement by giving a notice in writing (a 'requirement' notice) to the secured party. This would require the secured party to file a financing change statement within 15 days or commence court proceedings. If no court order has been obtained by the end of 90 days, or such longer period as the court may direct, the debtor can amend or remove the filing itself.[179]

3.134 The majority of those who responded, agreed that the secured creditor should file financing change statements at the debtor's request where the changes proposed are not disputed. However some were concerned that the procedure for enforcing a debtor's requirement notice would put undue pressure on creditors. They argued it would lead to an early recourse to unnecessary and expensive litigation by placing the onus on the secured party to initiate proceedings in order to maintain a filing. They feared that it could create an incentive for fraudulent debtors to argue about the scope of the security they created. They would prefer the onus of initiating court proceedings to be on the debtor, not on the secured party.

3.135 In the proposed system there can be no check on whether a charge exists or on whether the debtor has consented to the filing, other than the word of the party filing. Nor will there be any other check on whether the financing statement describes the collateral correctly. We have concluded that it is important that the debtor – or if no charge exists, the putative debtor – should have a ready method of challenging an inaccurate filing. We do not think that debtors are likely to abuse the system, since to do so would make it hard for them to obtain credit in future. Therefore we recommend the scheme proposed in the CR.

3.136 However, we have concluded that there should be an exception in cases in which the chargee is shown on the financing statement as being a trustee for others (for example, for a group of lenders). An oversight by the trustee might lead to the beneficiaries losing their security through no fault of their own. If the financing statement indicates that the chargee is a trustee (which will be optional), the person named as debtor should have to obtain a court order to have the financing statement amended or discharged.

3.137 **We recommend that**:

(1) The chargee should be able to amend the financing statement by filing an 'additional statement'.[180]

(2) The debtor (or any other person with an interest in the property) should be able to obtain the correction or removal of a financing statement by giving a notice in writing (a 'requirement' notice) to

[179] See CR paras 3.157-3.160; CR draft reg 55. This is an adaptation of the scheme used in the NZPPSA, with the difference that in New Zealand the secured party who is not willing to comply with the debtor's demand must obtain a court order within 15 days of receiving the demand: NZPPSA s 165.

[180] See draft regs 10-14.

the party named as chargee (or its agent). This would require the chargee to file a financing change statement within 15 days or commence court proceedings.

(3) If no court order has been obtained by the end of 90 days or such longer period as the court may direct, the debtor should be able to amend or remove the filing itself.

(4) If the financing statement indicates that the chargee is a trustee, the person named as debtor should have to obtain a court order to have the financing statement amended or discharged.[181]

Effect of unauthorised or accidental discharge

3.138 It is possible that the chargee or its agent might file an additional statement that is effective to discharge a financing statement by accident or without authority. In the CR we argued that the scheme should permit the re-activation of the filing on two conditions: (1) that other secured parties or buyers are not prejudiced and (2) that it is done within a short enough time that unsecured parties are unlikely to have relied on the apparent discharge. Therefore we provisionally recommended that where there has been mistaken or unauthorised discharge of a financing statement, the chargee should be able to re-activate the financing statement within 30 days. Where this is done, the discharge should not affect the priority ranking of the security interest as against those security interests which, prior to the discharge, were subordinate in priority to it. However, this should not apply to the extent that the competing security interest secures advances made or contracted for in the period between discharge and re-activation.[182] Most of those who commented on this proposal agreed with it.

3.139 **We recommend that**:

(1) where there has been a mistaken or unauthorised discharge of a financing statement, the chargee should be able to re-activate the financing statement within 30 days of discharge. Where this is done, the discharge should not affect the priority ranking of the charge as against charges or pledges which, prior to the discharge, were subordinate in priority to it.

(2) However, this should not apply to the extent that the competing charge secures advances made or contracted for in the period between discharge and re-activation. The Rules should deal with the procedure for re-activation of the financing statement.[183]

[181] See draft reg 16.

[182] CR para 3.170; CR draft reg 43.

[183] See draft reg 33. The CR version applied this also to cases in which a financing statement for a limited period had been allowed to lapse. We no longer see the need to provide for this case.

Search criteria

3.140 It should be possible to search by company name, company number or the number of the financing statement.[184] Now that the proposed scheme is limited to charges, the search criteria can be simpler than those proposed in the CR, which included searching by unique identifying number.

3.141 **We recommend that it should be possible to search the register on-line by the company name, the company registered number, if any, or the financing statement number (the number allocated by the registry on filing).**[185]

System failure

3.142 In the CR we said that the risk of major loss being caused by a system failure is low: if the system 'goes down' it will be evident to both filers and searchers, so that they will know that they must wait and try again. However there is inevitably a slight risk that a defect in the software, or hackers deliberately interfering with the system, might prevent a properly conducted search from revealing a registered charge. We asked consultees whether there should be a statutory, no-fault compensation fund for system failures; and fault-based liability for loss caused by errors in the system.[186]

3.143 There was little enthusiasm among consultees for a no-fault compensation fund. Many thought that in principle the Registrar should be liable for losses caused by any failures that were the result of negligence by Companies House. We think that the question of the Registrar's liability goes wider than just liability for any failings of the Company Security Register. Either it should be the subject of a comprehensive review (which is outside our terms of reference) or it should be left to the courts.

3.144 **We make no recommendation on whether the Registrar should be liable for loss caused by errors in of failure of the Company Security Register**.

PRIORITY

Introduction

3.145 The CR set out a detailed scheme of rules to govern the priority of security interests as against both other security interests and as against purchasers other than secured parties. As we explained in Part 2, many consultees were critical of the complexity of the rules on the priority of competing security interests. In contrast, there was wide, though not universal, support for simplifying the existing law so that priority would normally depend on the date of registration, and for clarifying the rules that apply to buyers and similar transferees of property[187] that is subject to a charge.

[184] In the CR we argued against adopting the system of the NZPPSA, under which searches may be made by the type of collateral: see CR para 3.128. There was no disagreement from consultees.

[185] See draft reg 15(2). On searches using 'near miss' criteria, see para 3.93 above.

[186] CR para 3.175.

[187] Eg, a person who leases the property under a finance lease.

3.146 We have explained that we are no longer recommending that the scheme for company security interests should apply to title-retention devices. Most of the complexity in the rules of priority was caused by the provisions on priority for purchase-money security interests. These were aimed principally at title-retention devices and are not needed if the latter are to be outside the scheme.[188] It is therefore possible to simplify the priority rules substantially.

3.147 Our recommendation that for the time being the distinction between fixed and floating charges should be preserved,[189] at least so far as insolvency is concerned, raises some issues about priority, since under current law the rules of priority vary according to whether the first charge is fixed or floating. In this section we will first consider the relative priority of fixed charges and pledges and then consider floating charges. Similarly, our discussion of the rules on 'buyers' will distinguish between fixed and floating charges.

3.148 This Part does not consider the special priority rules that are necessary for financial collateral. They are discussed in Part 5.

Priority between competing security interests

Fixed charges

3.149 Under current law, the relative priority of two fixed charges or mortgages depends upon the order of creation, subject to

(1) particulars of each charge being sent for registration within the 21-day period. A charge that is not registered in time will be void against any other creditor.[190] However, priority does not depend on date of registration. An equitable charge that has not been registered will take priority over a subsequent equitable charge provided that the earlier charge is subsequently registered within 21 days of its creation, even if the second charge was registered first; and

(2) the rule that a bona fide purchaser of the legal estate for value and without notice will take free of an equitable interest. Thus if the second charge is a legal mortgage which is taken before the earlier charge has been registered, the legal mortgage will gain priority, even if the earlier mortgage is subsequently registered within 21 days of its creation.

3.150 In the CP we criticised these rules as overly complex and obscure. The problem of '21-day invisibility' has the potential to do real injustice. Although respondents said that few priority disputes arose in practice, there was wide agreement with our criticisms. There was also broad agreement that it would be more satisfactory were priority between competing (fixed) charges to depend upon date of filing.

[188] See above, para 1.29.

[189] Discussed in more detail below, para 3.79.

[190] Companies Act 1985, s 395. Late registration may be permitted but usually only without prejudice to charges that have been registered in the meantime: see above, para 3.6.

3.151 In the CR we proposed a set of rules that would apply unless displaced by a more specific rule.[191] These 'residual' rules were as follows:

(1) Perfected security interests take priority over unperfected ones.

(2) As between secured parties with perfected security interests, priority is determined by whoever was first to file or perfect.

(3) As between unperfected security interests, priority is determined by date of attachment.

(4) The priority that a security interest has under the rules above applies to all advances, including future ones (whether or not made under an obligation).[192]

3.152 As far as fixed charges were concerned, all those who wanted to see a change to the priority rules agreed with (1) and (2). It was pointed out that it might be more consistent with current law were the contest in (3) to be settled by the date of creation rather than 'attachment'. We agree; indeed, we no longer see a need to define or use the concept of 'attachment' in the draft regulations.[193]

3.153 Rule (4) differs from current law and was more controversial. Under current law, after a chargee has received notice of a second charge over the same collateral, it may only 'tack' further advances if it is obliged to make them or if the second chargee agrees.[194] Although most of those who responded to the CP agreed with our proposed rule, others argued that no case had been made for a change in the law.

3.154 Rule (4) is integral to our recommendations. It follows from the nature of a notice-filing system, where priority depends on date of filing even if the filing was made before the charge came into existence. If a chargee can register a financing statement to cover a new agreement and thereby gain priority for any advances made under the new agreement over a charge registered in the intervening period,[195] it makes sense to allow it to tack further advances to an existing charge. We pointed out that it would always be possible for a second potential creditor to reach a subordination agreement with the first creditor. It will often be in the first creditor's interest for a further advance to be made by another creditor.

3.155 **We recommend as 'residual' priority rules for fixed charges that**:

(1) Registered charges should take priority over unregistered ones.

(2) As between secured parties with registered charges, priority should be determined by whoever was first to file its financing statement;

[191] For example, the rules that would have given priority to a purchase-money security interest.

[192] See CR draft reg 33(6).

[193] See above, para 3.204.

[194] Law of Property Act 1925, s 94(1): see CP 164 paras 2.56-2.57.

[195] Compare the position as against execution creditors, below, paras 3.201-3.204

(3) As between unregistered charges, priority should determined by date of creation.

(4) The priority that a charge has under the rules above should apply to all advances, including future ones (whether or not made under an obligation).[196]

Priority of pledges

3.156 In both the CP and, in effect, the CR[197] we proposed that, as in the UCC and PPSAs, the priority of a pledge as against a (fixed) charge should in general[198] depend on whether the financing statement relating to the charge was registered before or after the pledge was created. This nearly replicates the effect of the current law.[199] Most of those who wished to see the rules of priority altered agreed with this rule.

3.157 **We recommend that priority between a charge and a pledge be determined by whether the financing statement relating to the charge is registered before the pledge is created**.[200]

The distinction between fixed and floating charges

3.158 Before we consider the priority of floating charges we need to refer to back to a point made in Part 1. We explained that in the light of responses to the CR we have decided that, for the time being at least, the distinction between fixed and floating charges should be retained. In this section we explore the issue and explain our reasons in detail. We then return to issues of priority.

THE DISTINCTION BETWEEN FIXED AND FLOATING CHARGES UNDER CURRENT LAW

3.159 The most important distinction in practice between fixed and floating charges is that a floating charge allows the company to continue to dispose of assets subject to the charge in the ordinary course of business. This continues until the charge crystallises, for example when the chargee appoints an administrative receiver. The charge then attaches to whatever assets the company owns at that moment. It is this flexibility that enables a lender to take a security interest over the whole undertaking. Unless the company could (i) sell its stock-in-trade free of the charge[201] and (ii) pay its employees and 'trade' creditors, it could not function.

3.160 It is the right to dispose of stock-in-trade and to make payments that is crucial. Other assets such as equipment can be, and frequently are, made subject to fixed charges. To some extent it is also possible to take a fixed charge over book

[196] See draft regs 24(1)-(4).

[197] In the CR the rule was expressed in terms of date of filing versus date of perfection by possession.

[198] There will be exceptions where the item pledged is a negotiable instrument: see below, para 3.224.

[199] Currently it is the date of creation of the charge, subject to the 21-day period for registration, that is critical.

[200] See draft reg 24(5).

debts. However, in its recent judgment in the *Spectrum Plus* case[202] the House of Lords has held that a charge over book debts will be a fixed charge only if the proceeds of the debts have to be paid into an account over which the chargor has control. It seems that it not enough that the chargor has the right to prevent the chargee from drawing on the account without its consent; the account must actually be operated as a blocked account.[203] Alternatively, book debts may be subjected only to a floating charge but the charge may include a prohibition on factoring or other disposition of the book debts (often also referred to as a negative pledge clause).

3.161 In practice, lenders use a combination of fixed and floating charges to permit debtors to dispose freely of their stock-in-trade and cash payments. However, the devices that have to be employed to prevent other disposals (for example, fixed charges over book debts or clauses prohibiting assignment of receivables) are unreliable and uncertain in their operation. For example, a negative pledge clause or a clause in the charge document prohibiting assignment of receivables will only affect a party who has notice of it. Registering the clause does not put third parties on constructive notice.[204]

THE CR PROPOSALS

3.162 The scheme proposed in the CR provided (1) that under *any* charge there would be a right and a power to make the two essential kinds of disposition free of the charge; but (2) that the company would not have the right or power to dispose of any other asset unless this had been agreed between the parties. Thus the holder of a 'general' security interest over the whole of a company's existing and future assets would have priority over the company's equipment and its receivables against another secured party or an outright buyer of the receivables unless it agreed (in the charge agreement or subsequently) to the company disposing of them free of the charge. There would be no need, for example, to use a floating charge qualified by a prohibition on factoring or to combine a floating charge with a fixed charge over those assets that the lender did not want the company to be free to dispose of.

3.163 It would have remained possible to provide that the company could dispose of any other type of asset in the course of business. This might be useful if the company wanted that freedom.

3.164 Responses on our proposals to change the distinction between fixed and floating charges were particularly difficult to analyse. First, it has been hard to gauge whether there is real opposition to our proposals when correctly understood. The floating charge is viewed as enormously important. Some respondents appeared to think that we were suggesting that it should no longer be possible to create

[201] Except through very artificial devices such as field warehousing.

[202] *National Westminster Bank plc v Spectrum Plus Ltd* [2005] UKHL 41, [2005] 3 WLR 58, allowing the appeal from the decision of the CA in [2004] EWCA Civ 670; [2004] 4 All ER 995.

[203] *Ibid* at [140], referring to the speech of Lord Millett in *Agnew v Comissioners of Inland Revenue* [2001] UKPC 28, [2001] 2 AC 710, at [48].

[204] See below, para 3.177.

floating charges. That was not at all our intention. The scheme proposed was designed to enable fixed and floating charges as they currently exist to be superseded by a new single form of charge that would be more flexible and give the lender better protection. We believe that in terms of the law of security there is a good case for this change.

INSOLVENCY LAW AND THE FLOATING CHARGE

3.165 The main issue that concerned most consultees was apparently not the proposed change just described in itself but the impact it would have on insolvency law. Several key provisions of the Insolvency Act 1986 turn on the distinction between fixed and floating charges.

3.166 It is true that, were the scheme set out in the CR to be implemented, significant numbers of consequential amendments would be needed in particular to the Insolvency Act 1986. We believe, however, that few of them involve any issues of particular difficulty.[205] The only really significant problem relates to preferential creditors and the unsecured creditors' fund introduced by the Enterprise Act 2002. The current rule that preferential creditors and the fund have priority over the holders of a floating charge clearly would not work effectively if floating charges were to become obsolete.

3.167 The effect of the distinction between fixed and floating charges on insolvency has provoked a considerable amount of litigation, and insolvency experts[206] have told us they would like to see the distinction abolished if a suitable substitute can be found. Reform of insolvency law in its own right is outside our terms of reference. We must therefore assume that the priority of preferential creditors over floating charges[207] and the unsecured creditors' fund[208] is to be preserved. Therefore, were we to recommend its effective abolition, we would have to find some other formula that we could commend to Government as a replacement for the distinction between fixed and floating charges. It would need to be more-or-less insolvency 'neutral' in that it would not alter the position of preferred creditors very much; and it would have to be no more complex, and preferably simpler, than the current one.

[205] Much of the concern about the impact on the floating charge related to how the statement of rights and remedies would affect insolvency, in particular the misapprehension that the scheme would apply to an administrator appointed by a creditor. With the 'shelving' of the statement of rights and remedies this concern may be put to one side. There was also concern that, with the 'abolition' of the floating charge, an administrator would cease to have the current power to dispose of assets subject to a floating charge without getting the consent of the chargee or the court, and to use the proceeds to run the business. (Where property is subject to a fixed charge the administrator must get the consent of the creditor or the court and the funds must be set against the obligation secured.) We did not consider the point in the CR but there seems to be a straightforward answer to it: the administrator should have the same rights that the company had, ie, to dispose of inventory, to make payments to creditors and to dispose of other assets if the charge so permits. Thus in practice there would be little change on this point.

[206] Eg, the CLLS Insolvency Law Committee.

[207] We can certainly see an argument for giving them priority over all charges (see Calnan (2004) 9 JIBFL 341) but we doubt that it would be accepted because it would not be 'insolvency neutral'.

[208] We very much doubt whether Government would be prepared to abandon this so soon after its introduction.

3.168 We believe that it is possible to devise such a formula. With respect to preferential debts, the New Zealand legislation closely replicates under the notice-filing scheme the position of preferential creditors under the previous floating charge scheme. In essence, preferential creditors have priority over the claims of any secured creditor to the extent that the security:

(1) is over all or any part of the company's receivables and inventory or all or any part of either of them; and

(2) does not arise from a security over a receivable for which new value was provided at the time. [209]

3.169 We would not follow this exactly. The test of 'value was paid at the time' could be complex to answer and give receivables financiers and banks operational difficulties. We were told that even in the context of factoring, in which there is supposedly a direct correlation between the debts sold and the funds advanced, it is in practice common for the factor to 'over-advance', that is, to advance more than is represented by the company's existing debts, in the expectation that there will be further receivables that will make up the shortfall. It would be arguable that no 'new value' was given for the relevant receivables at the time they were received. This is even more likely with receivables charged to a bank to secure an overdraft. Even if it were possible for the bank to prove that it had advanced funds to match the receivable, the need to do so would require expensive monitoring and record-keeping. We think it would be simpler to give preferential creditors preference over all receivables.

3.170 Thus, were the proposals in the CR to be adopted, so that the distinction between fixed and floating charges would become obsolete, we would recommend that preferential creditors and the unsecured creditors' fund should have first claim on:

(1) any 'inventory' (raw materials and stock-in-trade) or receivables belonging to the company; and

(2) any other asset of the company that, under the charge agreement, the company had the right to dispose of free of the charge.

We believe that the effects of adopting this test would be broadly 'insolvency neutral'[210] and that the test would be a good deal easier to apply that the current one.

[209] NZPPS Amendment Act 2001, s 14, amending Companies Act 1993 Seventh Schedule, Clause 9. The provision is more complex than is stated in the text because (1) the New Zealand scheme applies to title-retention devices, so that inventory sold to the company under an RoT clause is treated as belonging to the company. However preferential creditors will not have priority where the resulting security interest is a 'purchase –money security interest', as it almost always will be; and (2) the New Zealand scheme applies to sales of receivables. Receivables that have been sold are therefore subject to the claims of preferential creditors except where they were transferred for new value, which will again normally be the case.

[210] The decision of the House of Lords in *Spectrum Plus* (see note 202 above) shows it to be difficult in practice to maintain anything other than a floating charge over receivables.

CONCLUSION ON FLOATING CHARGES

3.171 We believe that there is a good case for including in our scheme the provisions that would remove the distinction between fixed and floating charges. We also think an adequate substitute test is available to determine which assets preferential creditors and the unsecured creditors fund should have priority over.

3.172 However we recognise that insolvency law has undergone significant changes in recent years, and that there is great unwillingness to see further changes in the immediate future. To maintain it means that the scheme will have to be more complex than we like. It means that lenders will have to continue to use a 'cocktail' of fixed and floating charges when under the more radical approach advocated in the CR a single charge would have sufficed. However it does not make the scheme unworkable or prevent it being a substantial improvement on the current law.

3.173 In the light of this, we have decided not to recommend at present the changes proposed in the CR that would have had the result of removing the distinction between the fixed and the floating charge. The proposed rules should be considered again when insolvency law is next reviewed.

3.174 As a result, there need be only a few amendments of substance to the Insolvency Act 1986. We have already mentioned the amendment we recommend to section 245.[211] Below we discuss two further recommendations, to clarify the position of preferential creditors.[212]

3.175 **We recommend that the distinction between fixed and floating charges should be retained for the time being. The issue should be revisited when insolvency law is next reviewed**.

Priority of floating charges

3.176 It does not follow from the recommendation just made that all the current rules governing the priority of floating charges as against other interests should remain unchanged. In what follows we recommend changes that will make floating charges more effective than they are at present.

FLOATING CHARGES AND SUBSEQUENT CHARGES

3.177 Under current law, the general rule is that a floating charge will lose priority to a subsequent fixed charge. This is because the company is authorised to carry on its ordinary course of business and creation of subsequent fixed charges is taken to be in the ordinary course of business.[213] In practice many floating charges attempt to prevent this by means of a negative pledge clause forbidding the company to create charges that rank ahead of or equally ('*pari passu*') with the

[211] See above, para 3.85.

[212] See below, para 3.187. There may also need to be provisions to deal with the situation where payments are made to a secured creditor, and the relevant financing statement discharged, but the payments are later 'clawed back' by the liquidator under provisions of the Insolvency Act 1986. We would wish to ensure that the creditor's right to revert to the original security is not impaired.

[213] See CP 164 para 2.40, which referred to *Wilson v Kelland* [1910] 2 Ch 306, 313 and *Wheatley v Silkstone and Haigh Moor Coal Co* (1885) 29 ChD 715.

floating charge. The clause works simply by limiting the company's authority. A creditor who takes a fixed charge with knowledge of this provision will take subject to it - in other words, will not gain priority over the floating charge. However, the negative pledge clause itself is not required to be registered. Even if particulars of it are included in the registration, subsequent creditors will not have constructive notice of it, as the doctrine of constructive notice applies only to those items that must be registered.[214] Thus the clause does not provide reliable protection to the floating charge-holder.[215]

3.178 Another way lenders may seek to preserve their position is through automatic crystallisation. The floating charge may include an automatic crystallisation clause, under which the charge is said to crystallise on any attempt by the company to create a charge that would rank above or alongside the floating charge. However, such a device may be ineffective unless the subsequent chargee has actual knowledge of the clause. If it does not, the company will still have apparent authority to dispose of its assets in the ordinary course of business. Nor will the subsequent chargee be fixed with constructive notice of the clause, even if particulars of it are on the register at Companies House.[216] Moreover, automatic crystallisation clauses are risky. It is possible that if the charge has crystallised but the chargee (perhaps not knowing that the clause has been triggered) allows the company to continue trading in the ordinary course of business, the charge will be held not to crystallise on other specified events.[217]

3.179 We understand that in practice a subsequent creditor will not take the risk that there may be a negative pledge or automatic crystallisation clause and that it might be found to have had notice of it. If it wants to ensure its priority it will make a subordination agreement with the floating charge-holder. It would therefore be much simpler and it would strengthen the floating charge significantly if the charge-holder did not have to use these cumbersome and unreliable devices to protect its priority. This explains why a good number of respondents to the CR who thought that the distinction between fixed and floating charges should be maintained for some purposes nonetheless considered that the rules on their respective priority should be simplified, so that priority as between a floating charge and a fixed charge would depend simply on the date of registration.[218] We agree.

3.180 **We recommend that the priority of a charge against another charge or a pledge should depend on the date of registration of the financing statement whether the charge is fixed or floating**.

FLOATING CHARGES AND PREFERENTIAL CREDITORS

3.181 The scheme should contain provisions to clarify or prevent certain problems of 'circularity' that can arise under current law and might also arise under the

[214] Cf the position in Scotland, where the negative pledge clause is registrable: consequently, subsequent creditors will have constructive notice of it.

[215] See CP 164 para 2.42; and R Goode, *Commercial Law* (3rd ed, 2004) pp 664-666.

[216] See CP 164 para 2.44; and R Goode, *Commercial Law* (3rd ed, 2004) pp 687-688.

[217] See R Goode, *Legal Problems of Credit and Security* (3rd ed, 2003), paras 4-54-4-55.

scheme we recommend. Take the case in which a floating charge over all the company's assets in favour of the bank is registered, and later the company creates a fixed charge over some of the same property in favour of another lender. Under current law, the 'default position' is that the fixed chargee will be paid off first, then the preferential creditors and the unsecured creditors' fund, (we will refer to both as 'the preferentials'), then the floating chargee.

3.182 Under the existing law it can happen, however, that the fixed chargee takes with notice of a negative pledge clause in the floating charge, or that the fixed chargee agrees to be subject to the floating charge, as has happened in a number of reported cases.[219] Similarly, under our scheme, the floating charge will have priority over the fixed chargee. What should be the position of the preferentials, who have priority over the floating charge but not the fixed charge?

3.183 We think this is and will remain an uncommon situation. Save in unusual circumstances, it is unlikely that a lender will rely on a fixed charge that is junior to a floating charge.[220] Rather, the second lender will not advance funds unless it can get the floating chargee's agreement that the fixed charge will have priority.

3.184 However, we think it is best to avoid any doubt in both the case where the floating charge has priority by virtue of being registered first and when the parties have agreed that the fixed charge should have priority over an already-registered floating charge.

3.185 When there is no agreement, so that the floating charge has priority over the fixed charge, the floating charge-holder should have priority over the preferential creditors to the extent of any fixed charges over which it has priority. Suppose that when the company becomes insolvent it has net assets of £500,000; that £350,000 would be due to the preferential creditors and the unsecured creditors fund; that the floating charge-holder is owed £200,000 and the fixed charge-holder £100,000. The assets should be distributed as follows:

Floating charge-holder	£100,000 (in right of the fixed charge over which it has priority)
Preferential creditors, etc	£350,000
Fixed charge-holder	£50,000.

3.186 When there is an agreement that the fixed charge should have priority over the floating charge, that should also give it priority over the preferentials. Assuming the same figures as above, the distribution will be:

Fixed charge-holder	£100,000

[218] Or as against a pledge on the date of the pledge versus the date the financing statement relating to the charge was registered.

[219] Eg, *Re Woodroffe's (Musical Instruments) Ltd* [1986] Ch 366 and *Re Portbase Clothing Ltd* [1993] Ch 388.

[220] Or one that (under current law) might be junior if the fixed chargee could be shown to have notice of a negative pledge clause in the floating charge.

Preferential creditors, etc	£350,000
Floating charge-holder	£50,000.

This replicates, in effect, the current law in the absence of an agreement.[221]

3.187 **We recommend that the Insolvency Act 1986 should be amended to provide that**:

(1) As against the preferential creditors and the unsecured creditors' fund, a floating charge should have priority to the extent of any fixed charges over which it has priority.

(2) A subordination agreement by which the floating charge holder agrees that a subsequent fixed charge will have priority, or any other arrangement that a fixed charge will have priority to a floating charge, should result in the fixed charge also having priority over the preferential creditors and the unsecured creditors' fund.[222]

Liens

3.188 Although interests arising by operation of law, such as liens, are generally excluded from the scope of the draft regulations,[223] there may be a conflict between a lien and a charge over the collateral that is the subject of the lien. The CR recommended that the lien should have priority over other security interests and consultees agreed. Few consultees objected to the substance of the proposal.[224]

3.189 **We recommend that a lien that arises by operation of law should take priority over a charge, whether registered or unregistered**.[225]

Supporting obligations

SUPPORTING OBLIGATIONS IN GENERAL

3.190 Earlier we explained that where a charge is taken over a receivable, a document of title, a negotiable instrument or investment property which is supported by a right to the proceeds of a letter of credit or a guarantee or indemnity, a charge will also arise over the 'supporting obligation', unless the parties agree otherwise. If

[221] See *Re Woodroffe's (Musical Instruments) Ltd* [1986] Ch 366. This 'subrogation' approach seems more satisfactory in terms of policy than the result reached in *Re Portbase Clothing Ltd* [1993] Ch 388. There Chadwick J held that, as a result of the agreement made, the preferential creditors had priority over both charges. See R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) paras 5-60-5-61.

[222] These provisions will be drafted at a later stage.

[223] See above, para 3.27.

[224] Some argued that CR draft reg 39 was drafted in terms that were too narrow. We agree. The new regulation is in broader terms.

[225] Draft reg 31.

the charge over the principal obligation has been registered, the charge over the 'supporting obligation' should not have to be registered.[226]

3.191 Subject to one exception, the charge over the supporting obligation should have the same priority as the charge over the principal obligation.

SUMS DUE UNDER A LETTER OF CREDIT

3.192 The one exception relates to charges over sums due under a letter of credit.[227] Suppose that a receivable (such as the contract price owed to the seller of exported goods) is to be paid by a letter of credit. The letter of credit will be a supporting obligation; whoever takes an assignment of the receivable will be entitled to the sums paid under the letter of credit automatically, and there will be no need to file separately for them.[228] It is conceivable that the receivable will be assigned twice, for example once under a general assignment of receivables, and then again (probably by mistake) under some more specific arrangement. Under the rule recommended in the last paragraph, priority will depend on the order of filing. However it is possible that the second party to file will contact the bank that is liable on the letter of credit before the other chargee does. That should, we think, give it priority ahead of the earlier-filed charge. It means that the creditor who has to be paid by the bank is not the junior creditor because the other creditor had filed first.[229]

3.193 Article 9 of the UCC achieves this by treating the secured party that contacts the bank as having 'control'[230] over the sums due under the letter of credit, and giving priority to the party who has control.[231] We have adapted that approach.

3.194 **We recommend that a charge over a supporting obligation that is not separately registered should have the same priority as the principal obligation; but when the charge is over the sums due under a letter of credit, a chargee who notifies the bank of its charge should have priority over one who has merely registered**.[232]

[226] Para 3.48.

[227] In the CR we referred to these as the 'proceeds' of a letter of credit: see CR para 4.140 ff. We have changed the term used to avoid confusion with proceeds of other kinds, cf above, paras 3.49-3.58.

[228] See above, para 3.48.

[229] It is also possible that the charge over the principal obligation has not been registered. We think that giving notice to the bank should suffice to preserve the effectiveness of the charge over the proceeds of the letter of credit in the event of the chargor company's insolvency.

[230] On 'control' in other contexts see Part 5.

[231] UCC sections 9-107 and 9-329. Under US law a bank is obliged to pay the proceeds to the secured party only if has agreed to do so (UCC section 5-114(a)). In English law it has to do so if it has received notice; see CR para 4.141. We have followed the latter.

[232] See draft reg 26. If the bank is entitled to ignore notice of assignment because the letter of credit prohibits assignment of the sums due under it, the chargee will need to obtain the agreement of the bank.

Priority in transferred collateral

TRANSFERS BY THE CHARGEE

3.195 We recommended above that when a charge is transferred from one party to another it should be possible to alter the financing statement to record the transfer, but that this should not be required in order to preserve the effectiveness of the charge.[233] The transferee should have the same priority as the transferor had at the time of transfer.

3.196 **We recommend that where a chargee transfers its rights, the transferee should acquire the same priority with respect to the charge as the transferor had at the time of transfer**.[234]

TRANSFER BY THE DEBTOR

3.197 If the debtor company transfers collateral that is subject to a charge, the transferee will take subject to the charge unless the transfer is authorised or the situation is one in which the transferee will take free.[235] There may be implications for the priority of the charge. In the CR we explained that some of the PPSAs require a party who knows of the transfer to file against the transferee within a fixed period. We explained that we thought this imposed an unacceptable burden on the chargee while not offering much additional protection to subsequent persons dealing with the collateral. The charge would only have to be registered against the transferee if the chargee knew of the transfer, so enquiries about the provenance of the collateral would still have to be made.[236] We provisionally recommended that if collateral were transferred by the debtor to a party who took subject to the security interest, then provided the chargee's interest was perfected at the time of transfer and has remained so, it should have priority over any security interest created by the transferee. This should be so whether the security interest created by the transferee was created or filed before or after the security interest created by the transferor.[237]

3.198 Several consultees expressed concern that creditors who are unaware of the transfer or the identity of the transferor may not be able to find out about the charge. However, we still think that this rule is preferable to the alternatives, which may involve a loss to the first chargee.

3.199 We referred earlier to the issue of property that a company acquires from an individual or unincorporated body, subject to a charge. We explained that there is no need to require the chargee to register against the new owner.[238] The priority of the charge should also be protected as against charges created by the transferee company, whether before or after the transfer.

[233] See above, para 3.68.

[234] See draft reg 24(6).

[235] See below, paras 3.320 ff.

[236] See CR para 3.245.

[237] See CR para 3.246 and CR draft reg 37. The rule proposed is that found in UCC section 9-325.

[238] Above, para 3.63.

3.200 **We recommend that if collateral is transferred by the debtor to a party who takes subject to the charge, then provided the chargee's interest was (if necessary) registered at the time of transfer and has remained so, it should have priority over any charge created by the transferee. This should be so whether the charge created by the transferee was created or filed before or after the charge created by the transferor**.[239]

Priority as against unsecured creditors

Execution creditors

3.201 Under current law, an execution creditor cannot seize property that is subject to a duly registered fixed charge. In principle an execution creditor takes free of a floating charge if it has completed execution before crystallisation of the charge. In practice the attempted execution is likely to trigger an automatic crystallisation clause in the floating charge.[240] An automatic crystallisation clause is likely to be effective in this type of case, since the rights of the execution creditor do not depend on whether it had notice of the clause or of the crystallising event. Thus if there is such a clause the execution creditor will be unable to claim any of the debtor's property. However, we have seen that an automatic crystallisation clause is a risky device to have to use.[241]

3.202 In the CR we proposed that execution creditors should not be affected by a security interest that was not registered when the creditor attempts execution, but should take subject to any registered security interest.[242] Some consultees argued that the case for this change was not made out. We think it is justified because it will simplify the law and remove the need for complex and uncertain clauses in floating charge documents. We do not believe it will make much practical difference to execution creditors, who are already at risk of automatic crystallisation clauses, and who have a powerful alternative: where the debt amounts to more than £750, they can threaten insolvency proceedings.[243]

3.203 However, we also recommended in the CR that a secured party should not have priority in respect of further advances made after it knows that the execution creditor has acquired an interest in the goods, unless the secured party was under an obligation to make the advance.[244] This drew little comment.

3.204 **We recommend that:**

(1) An execution creditor should have priority over a charge that is unregistered at the time the execution creditor's interest arises.[245]

[239] See draft reg 27.

[240] See above, para 3.178.

[241] Again see para 3.178.

[242] CR para 3.250.

[243] See Insolvency Act 1986, s 123(1).

[244] CR para 3.252.

[245] See draft reg 20(4).

(2) An execution creditor's interest should be subject to a charge that was registered at the relevant time, whether the charge was fixed or floating.

(3) However, a chargee or pledgee should not have priority in respect of further advances made after it knows that the execution creditor has acquired an interest in the goods, unless at that time the chargee was under an obligation to make the advance.[246]

Distress for rent

3.205 The issue of the priority of a charge as against a distraining landlord was not discussed in the CR. The position appears to be that the landlord:

(1) can seize goods that are subject to an uncrystallised floating charge;[247] and

(2) may be able to seize goods that are subject to a fixed charge (including a floating charge that has crystallised).

There is doubt about a landlord's rights against a mortgagee, but it seems that if the tenant has any equity of redemption then the landlord may seize the goods and take the whole value. Further, if the chargee or mortgagee has, in addition to security over the assets distrained, a fixed charge or mortgage over the lease of the premises, then it seems reasonably clear that it cannot claim protection against the landlord's distraint.[248]

3.206 The Law Commission published a report on distress for rent in 1991.[249] It recommended the abolition of distress for unpaid rent for both commercial and residential tenancies. In March 2003, the Lord Chancellor's Department (as it then was) published a White Paper as part of its Enforcement Review.[250] This accepted the Commission's recommendations to abolish distress for rent against residential tenancies, but proposed its reform rather than abolition in commercial cases. No further action has been taken. We therefore need to cover the topic.[251] We should at least resolve the uncertainty of the current law. We propose to do this by providing that a landlord's right to distrain on goods for unpaid rent takes priority over any mortgage or charge over them, whether registered or not.

[246] See draft reg 24(11).

[247] *In re Roundwood Colliery* [1897] 1 Ch 373.

[248] Because has a 'beneficial interest' in the tenancy: Law of Distress (Amendment) Act 1908 s.1(c), *Cunliffe Engineering Ltd v. English Industrial Estates Corp.* [1994] B.C.C. 972.

[249] Landlord and Tenant: Distress for Rent (1991) Law Com No 194.

[250] Effective Enforcement Cm 5744, para 30. This followed a consultation exercise in May 2001 (Distress for Rent, Enforcement Review Consultation Paper No 5).

[251] We understood that there were plans to deal with the topic in a Courts and Tribunals Bill which has not yet been introduced.

3.207 **We recommend that a landlord's right to distrain on goods for unpaid rent should take priority over any mortgage or charge over them, whether registered or not**.[252]

Distress for rates

3.208 This right of the local authority is now statutory.[253] It was considered in *In re ELS Ltd*.[254] The relevant regulation[255] gave the local authority power to levy the amount of overdue rates by distress and sale of the goods of the debtor. Ferris J held that goods covered by a crystallised floating charge were not 'goods of the debtor' and so the chargee had priority.[256] An automatic crystallisation clause will therefore protect the chargee.[257] We think that it is sensible to deal with distress for unpaid rates in the same way as execution creditors. In other words, a registered charge, whether fixed or floating, should have priority.

3.209 **We recommend that a registered charge, whether fixed or floating, should have priority over the right of a local authority to distrain for rates.**[258]

Priority as against buyers

3.210 In this section we deal with the priority of a purchaser other than a secured party - for example, a person who buys the collateral or takes it on a finance lease. The CR proposed that an unregistered security interest would not affect a buyer who did not know of it. However, a registered security interest would normally bind a buyer, unless the sale (or other disposition not by way of security) was authorised by the security agreement (or subsequently).[259] We proposed that

(1) under *any* charge there would be a right and a power to sell its stock-in-trade free of the charge and pay its employees and 'trade' creditors; but

(2) the company would not have the right or power to dispose of any other asset unless this had been agreed between the parties.

As we explained earlier, this would have led to the floating charge being superseded.[260]

3.211 Consultees by and large agreed with the underlying principle that an unregistered charge should not affect an innocent buyer whereas a registered one should. However, in the light of our recommendation that the distinction between fixed

[252] See draft reg 32(1).

[253] Part 111 of the Non-Domestic Rating (Collection and Enforcement) (Local Lists) Regulations 1989 (amended by Non-Domestic Rating (Collection And Enforcement) (Local Lists) (Amendment) (England) Regulations) (SI 2003 No2210.)

[254] [1995] Ch 11.

[255] Draft reg 14(1).

[256] He followed the Court of Appeal decision in *In re Roundwood Colliery* [1897] 1 Ch 373, which concerned a landlord's right of distress for rent.

[257] As with execution creditors, the question of notice of the crystallisation is irrelevant.

[258] See draft reg 32(2).

[259] See CR 3.183.

and floating charges should be preserved at least for the time being,[261] we have had to revise the rules that should apply to buyers and similar transferees of property subject to a charge.

3.212 The CR also proposed regulations dealing with buyers of vehicles and similarly uniquely-numbered goods, and with low price goods bought for private purposes.[262] Since the revised scheme does not cover title-retention devices these provisions are no longer needed.

Buyers and unregistered charges

3.213 In the CP we explained that although a charge that is not properly registered under the Companies Act 1985 will be invalid as against the administrator, liquidator or creditors, other parties are not affected. Thus the charge will be valid against a buyer.[263] Whether the buyer takes free of the charge will depend on the nature of the charge and the general rules of priority. We proposed that any unregistered charge should be invalid against a buyer.[264]

3.214 There was wide support for this, but some consultees pointed out that to allow the buyer to take free even when it knows of the unregistered charge would give opportunities for fraud. For example, a director of a company might buy equipment from the company knowing that it was subject to an unperfected charge. Therefore in the CR we provisionally recommended that a buyer of collateral subject to an unperfected security interest should take free of it, providing value was given and the buyer was without knowledge of the security interest.[265] This proposal was generally supported.[266]

3.215 Where the unregistered charge is a floating charge the buyer should not be bound by it even if they know of it, unless the disposition is not in the ordinary course of business or they know that it is in breach of the security agreement.

[260] See para 3.162.

[261] Paras 3.175 ff.

[262] See CR paras 3.263 and 3.262.

[263] CP 164 para 2.58, referring to *Re Overseas Aviation Engineering (GB) Ltd* [1963] Ch 24, 38; *Stroud Architectural Systems Ltd v John Laing Construction Ltd* [1994] BCC 18, 24; W J Gough, *Company Charges* (2nd ed 1996) p 733; R Goode, *Commercial Law* (3rd ed 2004) p 667.

[264] CP 164 para 177. This is the rule that would have been introduced by the Companies Act 1989, s 95, had it been brought into effect. The Companies Act 1985, s 399 would have been amended to make a charge not registered within 21 days void against 'any person who for value acquires an interest in or right over property subject to the charge' after the 21-day period.

[265] CR para 3.256.

[266] Three consultees commented that the change would be more appropriate in the Sale of Goods Act than in companies legislation.

3.216 **We recommend that**:

(1) Transferees for value (other than a secured party)[267] of collateral that is subject to an unregistered fixed charge should take free of the charge unless they know of it.[268]

(2) Transferees of collateral subject to an unregistered floating charge, who acquire the collateral in a transaction which was in the ordinary course of the transferor's business, should take free of the charge unless they know that the transfer is in breach of the terms of the floating charge.[269]

Buyers and registered fixed charges

3.217 In the CP we explained that a buyer will take subject to a registered fixed charge, unless the doctrine of a bona fide purchaser of a legal estate without notice applies. There is some doubt as to when a purchaser who does not have actual knowledge of the charge will be put on notice of it because it has been registered. It is possible that a buyer of a capital asset would be expected to search the register but not one who buys stock-in-trade.[270] We think that it is desirable to clarify the law by providing that a buyer should be bound by a registered fixed charge.[271] (It is not feasible to create, or at least to maintain, a fixed charge over stock-in-trade, so sales of stock-in-trade will fall under the rules for floating charges discussed below.)

3.218 **We recommend that a transferee (other than a secured party)[272] of collateral that is subject to a registered charge which is a fixed charge should take subject to the charge unless the chargee has authorised the sale or other disposition**.[273]

Buyers and registered floating charges

3.219 It is in the nature of a floating charge that, until crystallisation, the company retains the power to dispose of its assets in the ordinary course of business free of the charge. Thus buyers will take free of the charge unless they know[274] that the disposition is not permitted because of some explicit restriction in the charge

[267] Priority as against secured parties will be governed by the priority rules recommended earlier in this Part. The same will be true of a buyer of accounts receivable: see below, para 4.18.

[268] See draft reg 28(1).

[269] See draft reg 28(3).

[270] R Goode, *Commercial Law* (3rd ed 2004) p 666; see also W J Gough, *Company Charges* (2nd ed 1996) p 840, who agrees that that this result is desirable in the case of a buyer of stock-in-trade but who doubts whether the authorities produce this result.

[271] The CLLS FLC, in its response of May 2005, said that this might narrow the protection of buyers as it is not clear that all buyers are expected to search the register. That may be true, but the uncertainty of the present law is unsatisfactory.

[272] And a buyer of accounts receivable: see below, para 4.18.

[273] See draft reg 29(1).

[274] Registration of the clause will not put the buyer on constructive notice; the latter does not apply to restrictions in the charge as these are not registrable: see above, para 3.177.

or because the charge has crystallised.[275] In practice buyers will not be affected by crystallisation of the charge except where they know that a receiver or administrator has been appointed[276] or the company has ceased trading. Although crystallisation in other circumstances will remove the company's actual authority to dispose of the assets in the ordinary course of business, it will usually still have apparent authority to do so.

3.220 Had the relevant Part of the Companies Act 1989 ever been brought into force it would have empowered the Secretary of State to make regulations for registration of crystallising events.[277] No consultee suggested that we should follow this approach, which we think is unnecessary. However, it would be valuable to set out the position of buyers clearly. We recommend that the new regulations should set out what in practice is the current position, that a purchaser of property subject to a floating charge should take free of it unless the buyer knows that the charge has crystallised so that the disposition will be in breach of the charge agreement.[278]

3.221 **We recommend that a transferee (other than a secured party)[279] of collateral subject to a registered charge which is a floating charge, who acquired the collateral in a transaction which was in the ordinary course of the transferor's business, should take free of the charge unless the transferee knew that the sale was in breach of the terms of the charge**.[280]

Transferees of negotiable collateral and money

3.222 It is vital to ensure that the transferability of negotiable instruments, negotiable documents of title and money (whether transferred in cash or by cheque or electronic transfer) is not compromised by the scheme. The draft regulations in the CR contained a number of provisions, derived from similar provisions in Article 9 of the UCC and the PPSAs, that were designed to ensure this. They provided in essence, that a holder in due course (whether a secured party or any other transferee) or other transferee for value who did not know of the security interest over the collateral would take free of it.[281]

3.223 Several consultees questioned the need for these rules, which seem either to overlap with provisions of the Bills of Exchange Act or to encapsulate rules of

[275] See CP 164 para 2.59.

[276] Registration under Companies Act 1985, s 405 (see below, para 3.292) does not amount to notice: R Goode, *Commercial Law* (3rd ed 2004) p 688.

[277] Companies Act 1989, s 100, introducing a new s 410 into Companies Act 1985.

[278] Where a receiver or administrator has been appointed, the buyer will take free because of the powers given to the receiver or administrator by the Insolvency Act 1986 (eg s 40 and Schedule 1B, as amended by Schedule 16 of the Enterprise Act 2002, para 70(1)). We do not consider it necessary to deal explicitly with cases where the company has ceased trading. When the company has ceased trading the disposition will not be in the ordinary course of business.

[279] And a buyer of receivables: see below, para 4.18.

[280] See draft reg 29(2).

[281] See CR draft reg 38.

common law. We agree, and in the new scheme they are replaced by simple 'saving' provisions.[282]

3.224 **We recommend that the rules of the scheme should be without prejudice to the rights of transferees of negotiable instruments, negotiable documents of title and money, whether transferred in cash or by cheque or electronic transfer**.

Fixtures

3.225 In the CR we asked whether the scheme should contain specific rules dealing with fixtures; it was our tentative view that they are unnecessary.[283] Those consultees who responded on the point agreed.

3.226 **We recommend that the scheme have no special provisions for the registration or priority of charges over fixtures**.

Crops

3.227 We provisionally recommended that a perfected security interest in growing crops (whether planted or natural) should have priority over a conflicting interest in the land, if the debtor has an interest in or is in occupation of the land.[284] The Land Registry supported this proposal on the grounds that it closely mirrors the provision in section 8(6) of the Agricultural Credits Act 1928.[285]

3.228 **We recommend that a registered charge over growing crops (whether planted or natural) should have priority over a conflicting interest in the land, if the debtor has an interest in or is in occupation of the land**.[286]

3.229 Finally, we asked consultees whether growing trees should be treated like other crops or should be left outside the scheme.[287] There was no clear view among the few who responded. The Land Registry pointed out that the Agricultural Credit Act 1928 probably applies to fruit trees but not timber. We think it is sensible to take the same approach. The provisions on crops will not apply to uncut timber; for the purposes of priority they will be treated as part of the land. Timber that has been cut when it is charged, however, will come within the definition of goods.

[282] See draft reg 30.

[283] CR paras 3.265-3.268.

[284] CR para 3.272.

[285] Overall, five consultees commented, of whom only one disagreed. He thought complications could arise if the new rules allow proprietary rights in crops to be dealt with separately from the land, but this is already possible. See Agricultural Credits Act 1928, s 8(6).

[286] CR paras 3.269-3.273.See draft reg 24(9).

[287] CR paras 3.271-3.273.

3.230 **We recommend that the definition of crops should exclude timber, so that timber that has not yet been cut will not fall within the definition of either crops or goods.**[288]

Priority and Assets for which there is a specialist register

Registered aircraft and ships and intellectual property rights

3.231 As we explained above, we now recommend that all charges created by companies registered in England and Wales[289] over registered aircraft and ships and intellectual property rights should be registered in the Company Security Register if they are to be effective in the debtor's insolvency, irrespective of whether the charge is also registered in the relevant specialist register. [290]

3.232 Under current law, registration at Companies House of charges over assets for which there is also a specialist register has some effect on priority. If particulars of the charge are not delivered within the 21-day period, the charge is ineffective against other creditors, while once it is registered other secured creditors will be treated as having constructive notice of the charge. However the schemes normally have their own rules of priority. For example, Article 14 of the Mortgaging of Aircraft Order 1972[291] stipulates a priority rule for the aircraft mortgage register. The basic rules are that registered aircraft mortgages have priority over unregistered ones; and that between two registered aircraft mortgages, priority is governed by the order of registration. There is a provision for entering priority notices on the register. Similarly, in the Register of Shipping and Seamen, there is a priority rule for registered ships to which the 'private law provisions'[292] relating to transfers and the registration of mortgages apply. Priority between competing registered mortgages is governed by the date and time of registration not by the date of creation or reference to any other matter. There is a provision allowing priority notices.

3.233 Patents, registered trade marks and registered designs each have a specialist register at the Patent Office. They allow for registration of mortgages, assignments and other interest in these intellectual property rights, and priority is determined broadly by reference to the date of registration. In the Patents Register, an unregistered mortgage or charge of which notice has not been given to the comptroller and of which a subsequent mortgagee or chargee is not aware would lose priority to that subsequent mortgage or charge.[293]

3.234 Because those involved with financing these types of assets expect to look at the specialist register, these specialist rules should not be affected by the general rule of our scheme that priority of competing charges will be by date of filing. For example, if two charges over a registered ship have both been registered in the

[288] Draft reg 42.

[289] For charges created by foreign companies over registered aircraft and ships, see below, para 3.272.

[290] See para 3.41 above.

[291] SI 1972/1268.

[292] Merchant Shipping Act 1995, Schedule 1.

[293] Patents Act 1977, s 33.

Company Security Register *and* the Ship Mortgage Register, but in differing order, it is the order of registration in the Ship Mortgage Register that should prevail. This replicates the effect of the current law.

3.235 **We recommend that where the legislation that establishes the specialist registry contains rules determining the priority of competing charges, those should apply in place of the general rule of priority from date of filing**.[294]

Land

3.236 Earlier we recommended that charges over unregistered land would have to be registered irrespective of whether they are also registered in the Land Charges Register. Registration must take place before the onset of insolvency if they are to be effective against an administrator or liquidator.[295]

3.237 With registered land, a fixed charge over land[296] registered or noted on the Land Register should not also have to be registered on the Company Security Register in order for it to be effective in an insolvency. Information about the registration or notice of a fixed charge should be forwarded by the Land Registry to Companies House for the purposes of information.[297] However, where charges are not so registered or noted on the Land Register or are floating charges, they should be registered on the Company Security Register.

3.238 In this section we consider the issue of priority of competing charges over land.

3.239 Our general approach is that priority between competing charges over land should be governed by the relevant real property legislation. Accordingly, where the rules of the Law of Property Act 1925, the Land Registration Act 2002 or the Land Charges Act 1972 apply, these will prevail over the scheme established for company charges in general. This will be the case irrespective of whether one or all of the competing charges over land have been registered at Companies House.

UNREGISTERED LAND

3.240 When the competition is between fixed charges over unregistered land, Law of Property Act 1925 section 97 provides that '[every] mortgage affecting a legal estate in land… whether legal or equitable (not being a mortgage protected by the deposit of documents relating to the legal estate affected) shall rank according to its date of registration as a land charge pursuant to the Land

[294] See draft reg 25(1).

[295] See above, para 3.38(3).

[296] Ie, over the legal estate. A charge over a beneficial interest under a trust of land that does not also charge the legal estate is not a charge over land for this purpose: see above, para 3.33 note 48.

[297] Ie whether or not the charge appeared on the Companies House register, and the order in which such information appeared, would not affect the effectiveness or the priority of the charge.

Charges Act'.[298] The order of priority of fixed charges over unregistered land should not be affected by the order in which the charges were registered in the Company Security Register. In other words, the priority scheme of the real property legislation should have priority over that of the scheme for company charges in general, as will generally be the case with charges over assets for which there is a specialist mortgage register.

3.241 In the case of a floating charge over unregistered land, the current law on priority is not completely clear. It seems likely that the rule in the Law of Property Act 1925[299] does not give priority to a floating charge over a subsequent fixed charge. That said, it seems that the subsequent fixed charge may be postponed to the floating charge if the latter contains a negative pledge clause that was known to the subsequent fixed chargee.[300] If this is so, it would be consistent with our general policy that under our scheme priority should be by date of registration in the case of unregistered land.

3.242 To make the point clear, we recommend that the scheme should provide expressly that the priority of a floating charge over a company's unregistered land as against competing charges over the same land depends on their respective dates of registration. If the financing statement covering the floating charge was registered before the date of registration of the financing statement covering the competing charge (or, where relevant, the date of registration of the charge in the Land Charges Register) then the floating charge should take priority. If it was registered after that date, then the competing charge should take priority.

REGISTERED LAND

3.243 By statute, a legal mortgage or charge over registered land will have priority over an earlier charge unless the earlier charge has been registered or is the subject of a notice on the Land Register.[301] In other respects the priority of competing charges is left to be determined by general law. The priority of competing fixed equitable charges is determined by the order of creation and is not affected by the entry of a notice on the register. We recommend that the priority of competing equitable charges should remain subject to the general law and that the general changes in the law to the priority of competing company charges should therefore take effect to determine their priority. The charges should rank in order of registration, whether that be registration of a financing statement on the Company Security Register (which may take place in advance of creation) or registration of a charge or entry of a notice at the Land Registry. In practice this

[298] It has been argued that this provision does not displace the ordinary priority rules as between fixed and floating charges since floating charges do not fall within section 97, as they do not 'affect a legal estate in land' in the sense that they do not create any proprietary interest prior to crystallisation: W G Gough, *Company Charges* (2nd ed 1996) pp 876-7.

[299] Law of Property Act 1925, s 97.

[300] The floating charge is registered only at Companies House (LCA 1972, s 3(8)). Entering particulars of the negative pledge clause will not of itself put the fixed charge-holder on notice of its existence: see above, para 3.177. Compare the position with registered land, next note.

[301] Land Registration Act 2002 ss 28-30. The priority of registered (legal) charges depends on the date of registration: s 48.

change will make little difference, since the order of registration is likely to be the order of creation.

3.244 Under current law a floating charge will normally lose priority to a subsequent fixed charge over the same property, unless the subsequent chargee has notice of a negative pledge clause in the floating charge agreement. It seems that under current law a negative pledge clause in a floating charge can readily be made effective in relation to registered land.[302] There would be little practical change if the priority of the floating charge as against the fixed were determined by order of registration under the general rule of our scheme. The only difference would be that a negative pledge clause would no longer be needed to achieve this result. We recommend the scheme should provide that the priority of a floating charge over a company's registered land as against competing equitable charges over the same land depends on their respective dates of registration. If the financing statement covering the floating charge was registered before the date of registration of the financing statement covering the competing charge (or, where relevant, the date of registration of the charge in the Land Register) then the floating charge should take priority. If it was registered after that date, then the competing charge should take priority.

3.245 **We recommend that**:

(1) The priority of fixed charges over unregistered land should not be affected by the date of registration in the Company Security Register.[303]

(2) The priority of a floating charge over a company's unregistered land as against competing charges over the same land should depend on their respective dates of registration. If the financing statement covering the floating charge was registered before the date of registration of the financing statement covering the competing charge (or, where relevant, the date of registration of the charge in the Land Charges Register) then the floating charge should take priority. If it was registered after that date, then the competing charge should take priority.[304]

(3) Subject to the provisions of the Land Registration Act 2002, the priority of fixed charges over registered land should depend on the order of registration, whether that be registration of a financing

[302] In relation to property in general, including the negative pledge clause in the particulars of the charge will not put third parties on notice of its existence because it is not a required particular. Under the Land Registration Act 1925, s 49 the floating charge would take effect as a minor interest, protected by a notice or caution. Gough suggests that a restrictive clause (or negative pledge) connected to the floating charge is likely to have been referred to in the notice, fixing subsequent chargees with actual notice of the clause. Further, where there is such a notice, the Registrar would not accept registration of a subsequent specific interest without written consent from the floating chargee, thus maintaining the priority of a floating charge with a restrictive clause as against a subsequent interest: see W J Gough, *Company Charges* (2nd ed 1996), pp 877 – 878. Since the scheme as regards the placing of notices on the register is similar under the Land Registration Act 2002, it seems likely that this position remains the same.

[303] See draft reg 25(1).

statement on the Company Security Register or registration or notice at the Land Registry.[305]

(4) The priority of a floating charge over a company's registered land as against competing equitable charges over the same land should depend on their respective dates of registration. If the financing statement covering the floating charge was registered before the date of registration of the financing statement covering the competing charge (or, where relevant, the date of registration of the charge in the Land Register) then the floating charge should take priority. If it was registered after that date, then the competing charge should take priority.[306]

TERRITORIAL APPLICATION

3.246 In this section we consider two broad issues: charges created by companies registered in England and Wales over assets elsewhere, and charges created by companies registered in other jurisdictions over assets that are in England and Wales. In this context, private international law ascribes a location to even intangible assets – so, for example, shares are usually treated as located where the issuer has its register or, if they are held through an intermediary, where the intermediary keeps its register.[307] We deal first with assets that are outside Great Britain and with 'oversea' companies, and then consider the position in respect to charges over assets in Scotland and charges created by companies registered in Scotland over their assets in England.

3.247 In the CR we explained that we had considered following the North American and New Zealand models,[308] which set down relatively comprehensive schemes dealing with the issues of private international law that may arise in relation to the validity, perfection and the effect of non-perfection, and priority of security interests. We concluded that it would not be sensible for us to try to regulate such issues of private international law.

3.248 First, it seems unnecessary to do so. It is true that the some aspects of the current law - for example, on what law governs the assignment of receivables - seem either unclear or less than wholly satisfactory, but we have not heard that the problems cause such serious difficulty in practice that we should embark on this difficult topic as part of this project.

3.249 Secondly, we think that it would not be practicable for England and Wales to alter its law in the way in which the law of North America has been altered. To put it simply, some of the rules adopted there make good sense if the 'foreign' jurisdictions that are likely to be involved have adopted broadly similar systems, but would not make sense in the European or wider international context, in

[304] See draft reg 25(2)(a).

[305] See draft reg 25(3).

[306] See draft reg 25(2)(b).

[307] *Dicey and Morris, The Conflict of Laws* (13th ed 2000) paras 22-042 – 22-045.

[308] See eg, NZPPSA ss 26-33; SPPSA, ss 5-8.

which there is enormous diversity. The necessary changes to English law would either be difficult to introduce, or would be ineffective because the 'new English rules' would probably not be followed in other jurisdictions.

3.250 Therefore in the CR we took the view that the scheme should deal only with questions of the registration and priority of security interests created by companies registered in England and Wales over their assets outside the jurisdiction, and to security interests created by companies incorporated elsewhere, or registered in Scotland, over assets here.[309] Consultees broadly agreed with this approach and in making our final recommendations we follow it.

Companies registered in England and Wales

3.251 Current law requires an English company to register at Companies House charges over its property wherever the property is situated.[310] Issues over the law governing validity and priority are left to the general law.

3.252 The registration requirement - or rather its only effective sanction, that an unregistered charge is 'void against the liquidator or administrator or any creditor of the company'[311] - is of limited effect in relation to collateral that is overseas.

3.253 The effectiveness of a charge over assets situated in another jurisdiction may arise in two different contexts. First, it may arise under the law of the place where the asset is situated, for example if there is a dispute between two parties each of whom claims an interest in the collateral, or if a creditor claims to have security over the assets but this is disputed by the liquidator acting on behalf of the unsecured creditors. Secondly it may arise on insolvency, in a dispute between a potential chargee and the body of unsecured creditors, when the law of the insolvency applies.

3.254 In the first situation - for example when the dispute is between a chargee and an execution creditor – the matter will be determined according to the *lex situs.* The issue of whether the charge is registered under English law is unlikely to be relevant to the legal system according to which the question is decided. For example, a charge might be recognised by English law but give no rights under the *lex situs* (for example, because the *lex situs* does not recognise non-possessory security over that type of asset).[312] The charge will not therefore be enforced. If on the other hand the *lex situs* does recognise that the chargee has

[309] CR para 3.346.

[310] The requirement applies to both the charges listed in Companies Act 1985, s 396 when created under English law and any transaction under foreign law that would be classified by an English court as creating such a charge: *Re Weldtech Equipment Ltd* [1991] BCLC 393, 395 (though there the assets were treated as being in England); *Dicey & Morris, The Conflict of Laws* (13th ed 2000) para 33-112.

[311] Companies Act 1985, s 395(1).

[312] Eg, Scots law does not recognise fixed non-possessory charges over goods.

an interest in the assets,[313] it is likely to enforce that right whether or not the charge has been registered in England and Wales.[314]

3.255 In the second case, as the Scottish Law Commission put it in their report:

> … on liquidation or receivership a question may arise as between the holder of the security and the body of general, unsecured creditors whether assets beyond the territorial jurisdiction of the country in which the company is incorporated and under whose system of law the charge security was created are embraced by the… charge. The decision in re *Anchorline v Henderson Brothers Ltd*[315] is such an example, a floating charge granted by an English registered company being held, in England, to give its holder right to the proceeds of the company's assets situated in Scotland. Such a question appears essentially to be one for the law of the country of liquidation or receivership, that is to say, normally the law of the country of incorporation.[316]

In English insolvency proceedings such as those in *Anchorline*, a registered charge was effective against the unsecured creditors even though (at that time) a floating charge was not valid under the law of Scotland where the assets were.

3.256 The main reason for including overseas assets within our scheme is to deal with the second situation, in which there are insolvency proceedings in England and Wales. The English court may exercise its jurisdiction *in personam* over the liquidator to enforce the contract between the chargee and the company, and may require the liquidator to pay the proceeds to the chargee, as it did in *Re Anchorline*.[317] This outcome under current law depends upon the charge being properly registered in England and Wales. We thought that any change would risk misleading unsecured creditors and possibly subsequent secured parties. We concluded that we should maintain the approach of the current law, so that a charge over assets should be registrable no matter where the assets are situated. The overwhelming majority of consultees who commented on this question agreed.

3.257 However, we also agree with some consultees that it should be made clear in the regulations that they do not affect rights acquired by the chargee or third parties

[313] See, for example, *Gordon Anderson (Plant) Ltd v Campsie Construction Ltd and Anr* [1977] SLT 7.

[314] In this respect the position of the Scottish courts will probably differ from that of courts overseas. See below, para 3.278 note 347.

[315] [1937] Ch 483.

[316] *Report on Registration of Rights in Security by Companies* (Scot Law Com No 197), para 5.3.

[317] *Re Anchor Line (Henderson Brothers) Ltd* [1937] 1 Ch 483. This jurisdiction is described as 'well-settled' though also as 'anomalous': *Dicey & Morris, The Conflict of Laws* (13th ed 2000) paras 30-122 and 23-048. We received no suggestions that it should be abolished.

in assets that are in another jurisdiction according to the law of that jurisdiction.[318] This is for two reasons. First, a chargee then will know that if it has acquired rights under the *lex situs* its interest will be valid without registration here, and that the priority of its charge will depend on the *lex situs*. Secondly, it respects the fundamental rule of private international law that proprietary issues such as perfection and priority are governed by the *lex situs*.

3.258 **We recommend that the regulations should apply to charges created by a company registered in England and Wales over its assets wherever they are located but without prejudice to the rights acquired by the chargee or third parties in assets according to the law of the jurisdiction where the assets are situated**.[319]

Companies incorporated outside Great Britain

3.259 There is universal agreement that the current law that applies to charges created by companies incorporated outside Great Britain ('oversea' companies) is profoundly unsatisfactory and must be changed. The current law was examined in detail in the CP. In brief, Companies Act 1985 section 409(1) extends the provisions of Part XII, Chapter I to charges on property in England and Wales which are created by an 'oversea' company which has an established place of business in England and Wales.[320] In *NV Slavenburg's Bank v Intercontinental Natural Resources Ltd*[321] Lloyd J held the effect of the provisions to be that if the company has a place of business here, particulars of the charge must be sent for registration even though the place of business has not been registered, and thus the company did not appear on the companies register. It will often be far from clear to the lender that the company has no place of business in England and Wales that should have been registered. The rule leads to frequent precautionary attempts to register. In practice Companies House merely records that the documents were sent and returns them, with a letter confirming that the charge was sent for registration and thus that any statutory requirement has been met. It is impossible for searchers to find out about such 'registered' charges, which defeats the object of registration.[322]

[318] We believe this represents the practical position in the majority of cases. It is possible that under current law an English creditor might obtain an injunction against the chargee to prevent it enforcing an unregistered charge. Although such an injunction will not be enforced in a foreign court it will be effective if the defendant is present within the England and Wales, or has assets there that may be sequestered in proceedings for contempt of court. However we are not aware that this is more than a theoretical possibility. We think it better to make the rule reflect what we understand to be the normal case.

[319] See draft reg 2.

[320] The provisions also apply to charges on property in England and Wales that are acquired by such a company. The requirements for a company to keep copies of instruments creating charges and a register of all its charges also apply: see the Companies Act 1985, s 409(2).

[321] [1980] 1 WLR 1076.

[322] For this and other criticisms see CP 164 paras 3.37-3.40. Companies Act 1989, s105 and Sch 15 if brought into force would have introduced a new Part XXIII, Chapter III, reversing the effect of the *Slavenburg* case by requiring only charges created by registered foreign companies to be registered.

3.260 Since the *Slavenburg* decision, amendments have been made to Companies Act 1985[323] in order to implement the Eleventh Company Law Directive.[324] Companies that have a branch here must register that under s 690A; they are then exempt from having to register a place of business even if they have one.[325] Companies with a registered branch here must deliver particulars of charges over property in Great Britain[326] but there is no such requirement on a company that has a branch but has not registered. [327]

3.261 Those who responded to the CR were divided on what should replace the current law. There was support for three views: (1) that no charge created by an oversea company should be registrable. The place for registration and searching is the state in which the company is incorporated or registered; (2) that charges created by oversea companies that have in fact registered a place of business should be registered but not others;[328] (3) that any charge created by an oversea company should be registered, as we recommended in the CR.

3.262 The first option, that no charge created by an oversea company should be registrable, has its attractions. In some ways it would be very much easier if for each company there were just one place in which it is necessary to file or to search, and the natural place is the state in which the company is incorporated or registered. Revised Article 9 of the UCC provides, in effect, that filing should take place in the jurisdiction in which the debtor company is registered. However, we reject this approach because it is not workable in our context in which most of our trading partners, particularly in Europe, have no directly equivalent registers. Although many jurisdictions require registration of certain types of charge, they are likely to apply only to charges that are recognised in the jurisdiction, and there can be no certainty that they will require registration even of those types of charge when the collateral is in what to them is a foreign jurisdiction. If charges created by all oversea companies were to be exempted from registration, those seeking to buy or take security over the 'English' assets of the oversea company, or simply trying to assess its credit-worthiness, would have great difficulty in discovering information about charges that would affect them.[329]

3.263 In addition it seems appropriate that domestic English law, as the *lex situs*, should continue to apply to questions of priority over collateral that is in England and Wales; and under our scheme priority depends principally on date of registration. It would certainly be possible to exempt charges created by oversea

[323] By Oversea Companies and Credit and Financial Institutions (Branch Disclosure) Regulations 1992, SI 1992 No 3179, reg 3(1), Sch 2, Pt I, paras 1 and 2.

[324] 89/666/EEC.

[325] Companies Act 1985, s 690B.

[326] Companies Act 1985, s 703D.

[327] Companies Act 1985, s 703A(3).

[328] As we proposed in CP 164 para 5.93.

[329] The UCC attempts to overcome this problem by a rule that if the debtor's home state does not have a registration system that requires filing as a precondition of validity of the security interest on insolvency, the secured party must file against the debtor in the District of Columbia: see section 9-307(c). The net effect of applying such a rule to our scheme would be very similar to requiring filing of all charges created by oversea companies over their assets in England and Wales.

companies over their assets here from all the rules of the scheme but it would result in them being left subject to the current law. That would create unfortunate fragmentation of the law.

3.264 There is no doubt that the second approach, that charges created by oversea companies that have in fact registered a place of business should be registered but not others, would be in some ways be the easiest of the three. By definition Companies House will have a record of such companies and the company can have a registration number against which the name can be cross-checked.[330] However, we said in the CR that a scheme that applied only to companies with places of business here would not offer sufficient protection to buyers or potential secured parties. We also suspected that modern business methods may enable companies to operate in Britain on quite a large scale without having a 'place of business' here, for example, if their goods are stored with third parties. Moreover, a 'registered place of business' solution would not be appropriate were the scheme to be extended to unincorporated debtors, which will not have any obligation to register even if their sole place of business is in England and Wales.[331]

3.265 In the CR we favoured the third solution, that the scheme should apply to charges created by any oversea company over its assets in England and Wales. We argued that this approach has advantages for all concerned. First, whether the company is a British one or a foreign one, parties who are thinking of buying or taking security interests over the goods in England will want to able to check to see what SIs may exist over them already, as will unsecured creditors wishing to know whether they have any chance of being able to levy execution against the company's goods in England. Secondly, we thought that secured parties taking security interests over the 'English' assets of foreign companies would appreciate the certainty of knowing that if they had registered, their interest would be valid and (subject to the normal rules) its priority will be protected. Thirdly, this would help the debtor company, as it would be able to offer better security to creditors.[332]

3.266 One argument used against the third approach was that overseas lenders taking security over an oversea company's 'English' assets might not be aware of this 'local' registration requirement and might find their charge unexpectedly unenforceable. We are not convinced that this is a serious problem. First, particulars of charges created by oversea companies that do not have a registered place of business here are sent in large numbers to Companies House. This suggests a degree of awareness of 'local' registration requirements. Secondly, we think that any lender relying on security over assets outside the company's 'home' jurisdiction should be aware that the *lex situs* may have different or additional requirements. We still think these arguments carry weight.

3.267 Thus while none of the three solutions can be shown conclusively to be the best, on balance we prefer the third solution, at any rate until such time as a majority of our trading partner states have registers of charges (including those created by

[330] See above, para 3.101.

[331] CR para 3.367.

[332] CR para 3.365.

companies registered in the state over their assets in other jurisdictions). We are reinforced in this view by the fact that the third solution was the one supported by a majority of the members of the working group established by the Law Society, which made a particular study of this issue. We are very grateful to them for the trouble they took.

3.268 **We recommend that the full scheme should apply to charges created by any oversea company over assets in England and Wales**.[333]

3.269 Goods owned by an oversea company may be brought into this country while they remain subject to security of some kind created in another jurisdiction. If this amounts to a charge under English law it should be registered, so that other creditors will know that the goods are subject to a charge, but there seems to be no need for registration to be made immediately. Unsecured creditors are very unlikely to rely on the company's possession of apparently unencumbered goods until some time has elapsed; and potential secured creditors can be expected to discover that the goods have been imported recently and make appropriate enquiries. Therefore, like the scheme proposed in the CR,[334] the regulations provide a 60-day grace period for registering existing charges over imported goods.[335] If the charge is registered within the 60-day period it will be treated as having priority from when the original charge was created. However a party who buys the goods before the charge is registered and does not know of it will take free.

3.270 **We recommend that existing charges over goods brought into the country by an oversea company should have to be registered within 60 days of the import**.[336]

3.271 Some goods, for example, aircraft, ships and lorries, are likely to be brought into the country and taken out again regularly. Under the regulation just described any charge over them would only have to be registered if any stay were to exceed 60 days. However even this may be inconvenient and with registered aircraft and registered ships belonging to oversea companies it can be avoided to some extent by treating them as 'situated' in the country where they are registered, regardless of their actual location at the relevant time.

3.272 **We recommend that for the purposes of the scheme, registered aircraft and registered ships belonging to oversea companies should be treated as 'situated' in the country where they are registered, regardless of their actual location at the relevant time**.[337]

[333] See draft reg 3(1).

[334] See CR draft reg 13(4)-(6).

[335] This makes it unnecessary to replicate the exemption for charges over imported goods brought about by the Bills of Sale Act 1890, s 1.

[336] See draft reg 21.

[337] See draft reg 3(2).

Collateral in Scotland

3.273 In this section we deal with the case of security created by a company that is registered in England and Wales over assets in Scotland.

3.274 The law of security in Scotland is different from that in England and Wales.[338] For example, Scots law does not recognise fixed non-possessory charges over goods, nor can a fixed security be created over an incorporeal such as a debt unless the debt is assigned and notification of the assignment is given to the account debtor.[339] Thus were a company registered in England to purport to give a fixed charge over equipment that was in Scotland,[340] the charge would simply be ineffective to confer any proprietary right on the chargee.[341] If it were to create a fixed charge over its book debts payable in Scotland, the charge would only be effective to confer any proprietary rights if the chargee notified the account debtors.

3.275 The floating charge was introduced into Scots law by statute in 1961.[342] Particulars of charges created by companies registered in Scotland are registrable at Companies House in Edinburgh. It appears that under current law, a floating charge created by an English company will be treated as effective in Scotland provided that it was properly registered in England and Wales.[343]

3.276 The Scottish Law Commission has also been considering the registration of rights in security created by companies. In its report it recommends that in order to constitute a floating charge under Scots law it should be necessary to register the text of the deed in a Register of Floating Charges.[344] There should no longer be any requirement to register any security created by a company with the Registrar of Companies.[345]

3.277 If this recommendation were implemented it would mean the end of the 'reciprocal registration' arrangements, even if no change is made to the law of England and Wales affecting company charges. As the SLC report puts it, 'a floating charge granted by a company incorporated in England and Wales and intended to be effective in Scotland as respects assets located in Scotland should require to be registered in the Register of Floating Charges'.[346] The practical effect would be that those taking floating charges over all the assets of 'English' companies that have property north of the border might find it necessary both to

[338] A much fuller account of Scots law will be found in the Scottish Law Commission's Discussion Paper on Registration of Rights in Security by Companies, DP No 121.

[339] DP No 121, para 4.5.

[340] It is not clear whether the Scottish courts would recognise the charge if at the time it was created the equipment was in England. It may be argued that the Scottish court should apply English law as the lex situs at the time.

[341] If the contest were in an English court between the chargee and the liquidator, the charge would be enforced under the *in personam* jurisdiction: see above, para 3.256.

[342] Companies (Floating Charges) Act 1961.

[343] And vice-versa: see below, para 3.281.

[344] Paras 7.1-7.3.

[345] *Report on Registration of Rights in Security by Companies* (Scot Law Com No 197), Part 7, recommendations 1, 2, 4 and 13.

[346] Para 7.20.

submit particulars to the Registrar of Companies in Cardiff (or under our recommended scheme, to file a financing statement on the company securities register) and to register the terms of the deed on the Register of Floating Charges in Scotland.

3.278 It would in principle be possible to provide that a floating charge that applied only to the 'English' company's 'Scottish' assets should not have to be registered in England and Wales; searchers could discover the charge by searching the Register of Floating Charges. However that seems unattractive. First, it would mean that a party interested in the overall state of the company would have to search in two places.[347] Secondly, we think it will be very uncommon that the company will create separate floating charges over its assets in Scotland and its assets in England and Wales respectively. There would be no saving in so doing. We therefore conclude that even such a charge should in principle remain registrable in England and Wales, though (as with charges created by English companies over their assets in jurisdictions outside Great Britain) this will be without prejudice to the rights acquired by the chargee under the *lex situs*.[348]

3.279 Other forms of security granted by an English company over its assets in Scotland will continue to be enforceable in Scotland only so far as the security is recognised by Scots law and is duly registered in England and Wales. These too should remain registrable in England and Wales, subject to the same proviso.

3.280 **We recommend that a charge created by an English company over assets in Scotland should be subject to the scheme, including the normal rules of registration**.

Charges created by Scottish companies over assets in England and Wales

3.281 Under current law, most charges created by a company registered in Scotland over its assets south of the border are registrable at Companies House in Edinburgh.[349] It seems that an English court will enforce them provided they have been so registered.

3.282 If the SLC's recommendations were to be implemented, no charges created by companies would be registrable at Companies House in Edinburgh. We think that charges created by companies registered in Scotland over their assets in England and Wales should then be treated in the same way as those of oversea companies; they should be registered in the Company Security Register and

[347] Unless the Register of Floating Charges were to forward information about floating charges created by companies registered in England and Wales to Companies House.

[348] We argued earlier that generally the courts of the *situs* will not have regard to whether a security that is valid under the *lex situs* was duly registered in England and Wales. In this respect the position of the Scottish courts is probably different. They may not think it right to disregard provisions made by or with the authority of the Westminster legislature. The proviso for rights acquired under the *lex situs* would mean that absence of registration on the Company Security Register would not affect the effectiveness of the floating charge under Scots law.

[349] There is a lacuna in that the list of registrable charges in section 410 of the Companies Act 1985 does not include fixed charges over goods, presumably because these are not valid under Scottish law.

should be subject to the other rules of the scheme. This should include floating charges, even if they were registered in the Register of Floating Charges.[350]

3.283 Were Scots law to remain unchanged, we think that it would be possible to exempt charges over their English assets from the requirement to file at Companies House in Cardiff; registration in Edinburgh could be treated as a surrogate. The information that would be registered in Edinburgh could, we understand, be made available to anyone who searched the Company Security Register; the information is much the same as would be on the financing statement. Priority would depend on the normal rules of the scheme.

3.284 **We recommend**:

(1) If the scheme of registration of charges created by companies registered in Scotland remains unchanged, registration at Companies House in Edinburgh should be treated, in relation to the company's assets in England, as due registration for the purposes of English law; the remainder of the scheme should apply to charges created by a Scots company as it does to an oversea company.

(2) If the recommendations of the Scottish Law Commission are implemented,[351] charges created by a company registered in Scotland over assets in England and Wales should be treated in the same way as charges created by an oversea company.[352]

TRANSITIONAL PROVISIONS

Existing charges that have been duly registered

3.285 In the CR we provisionally recommended that pre-commencement registrable charges that were registered before commencement should be treated as perfected under the scheme. They should retain their existing priority as against other pre-commencement charges and pledges. As against post-commencement security interests, their priority should depend on the normal rules of priority of the new scheme.[353] In practice this means that a pre-commencement registered charge, whether fixed or floating, will have priority over post-commencement interests.

3.286 This was generally welcomed, and we confirm it as our final recommendation.

3.287 **We recommend that pre-commencement registrable charges that were registered before commencement should be treated as registered under the scheme. They should retain their existing priority as against other pre-commencement charges and pledges. As against post-commencement**

[350] Presumably a floating charge created by a Scottish company over only its assets in England and Wales would not require to be registered on the Register of Floating Charges, since it would be created under English law.

[351] The draft regs have been prepared on this assumption.

[352] See draft reg 3.

[353] CR para 3.393.

security interests, their priority should depend on the normal rules of priority of the new scheme.[354]

Existing charges that are not currently registrable

3.288 On charges that are not registrable under current law (which would include those created by oversea companies that do not have a place of business here), we asked whether there should be a transitional period during which pre-commencement charges that are not registrable under current law should have to be registered.[355] Without that there would continue to exist a set of invisible but effective charges. However the cost would be significant - not so much the cost of the filing itself but the cost of determining whether financial institutions have previously unregistrable charges that need to be perfected. We were told that the records of many secured parties are incomplete or not in a form that makes it easy to determine such a question.

3.289 The general response to our question was that the additional information that would be gained would not justify the cost involved.

3.290 **We recommend that charges which before commencement of the scheme were not registrable should not have to be registered after the scheme comes into effect. They should retain their existing priority as against other pre-commencement charges and pledges, and (whether fixed or floating) should have priority over post-commencement interests**.[356]

PROVISIONS OF COMPANIES ACT PART XII

3.291 The scheme that we have recommended in this Part would replace the vast majority of provisions in Part XII of the Companies Act 1985. There are some other provisions that require discussion.

Registration of enforcement of security

3.292 Section 405 provides that if a person obtains an order for the appointment of a receiver or manager of a company's property, or appoints such a receiver or manager under powers contained in an instrument, he shall within 7 days of the order or of the appointment under those powers, give notice of the fact to the registrar of companies; and the registrar shall enter the fact in the register of charges.

3.293 We did not discuss this section in the CR. In discussion with consultees, it was suggested that it should be preserved. We see no reason not to do so.

3.294 **We recommend that the new scheme should provide for the registration of the appointment of a receiver or manager**.[357]

[354] See draft reg 46(3).

[355] CR para 3.397.

[356] See draft reg 46(4). It might be appropriate for the search system to give a warning that pre-commencement charges that were not registrable will not be revealed by a search.

[357] See draft reg 18.

Companies to keep copies of instruments creating charges

3.295 Section 406 requires every company to keep a copy of every instrument creating a charge requiring registration at its registered office.[358] Under section 408 these must then be open to inspection by members of the company and creditors.

3.296 We see no reason to retain this provision from the point of view of the law of security. Those dealing with the company (a wider group than is covered by section 408) will have access to the Company Security Register. They will thus be able to find out about the charge and they can ask the debtor company to supply further information, including a copy of the charge document if they need it. However, we think that whether or not this provision should be retained may raise issues beyond those of security law, since members of the company may have interests different to those of secured and unsecured creditors. Accordingly we make no recommendation on the point.

3.297 **We make no recommendation as to whether or not sections 406 and 408 of the Companies Act 1985 should be retained in any new legislation**.

Companies' registers of charges

3.298 Section 407 requires a company to keep a register of all charges (whether or not registrable at Companies House) at its registered office. It must give a short description of the property charged, the amount of the charge and, except in the case of securities to bearer, the names of the persons entitled to it. Under section 408 the register of charges must be open to the inspection of any other person on payment of a fee not exceeding 5 pence for each inspection.

3.299 In the CP we suggested that the company's own register of charges fulfilled no useful function in this context, and was not worth maintaining. Consultees in general agreed with our suggestion. From the point of view of securities law, if all charges (save those over financial collateral where the chargee has obtained control)[359] are to be shown on the Company Security Register, there seems no reason to require the company to keep its own register.

3.300 **We consider that from the point of view of the law of security, there is no reason to require the company to keep its own register**.

[358] 'Every company shall cause a copy of every instrument creating a charge requiring registration under this Chapter to be kept at its registered office': Companies Act 1985, s 406(2).

[359] See below, para 5.68.

SHOULD CHARGES BE EVIDENCED IN WRITING SIGNED BY THE DEBTOR?

Why require writing signed by the debtor?

3.301 In the CP we provisionally proposed that, as under Article 9 of the UCC and the PPSAs, a written security agreement signed by the debtor[360] should be necessary for any non-possessory security interest.[361] There was unanimous support for this from those who commented. In the CR we doubted the value of the requirement and, because it would be complicated to draft, we recommended that there be no requirement.[362]

3.302 Responses that we received to the CR were generally supportive. For example the Financial Law Committee of the City of London Law Society said they were strongly opposed to any additional requirement of writing.[363]

3.303 We have been concerned that companies buying goods subject to a retention of title (RoT) clause might find that by accepting the goods on the supplier's standard terms and conditions they have unwittingly agreed to a charge in the form of an 'extended' RoT clause over any new goods that are made from the goods supplied and over the proceeds of sale of either the original or the new goods.[364]

3.304 The courts have almost invariably held that extended clauses amount to floating charges that are registrable under Companies Act 1985, section 395.[365] In practice these charges are seldom registered, probably because, unless a special 'master agreement' were made, it would be necessary to register each transaction under which goods are supplied on RoT. Under our scheme, the reduced cost of filing and the possibility of filing just once to cover a series of transactions between the same parties will make it much less costly to register charges. The supplier may insist on registering the charge created by the 'extended' RoT clause and this might affect the buyer's ability to raise finance on the strength of its stock-in-trade or to factor their debts. Financiers who have existing arrangements with the buyer will normally have filed already and will not

[360] This would have included writing in the form of an e-mail or other electronic communication, even if it were 'signed' merely by the debtor placing its name at the end of the message or even clicking on a website button, provided that the form of 'signature' would reasonably indicate that the sender intended to authenticate the document. See *Electronic Commerce: Formal Requirements in Commercial Transactions – Advice from the Law Commission*, December 2001, para 3.39. If writing were to be required, we do not see the need to require greater formality, eg, a digital signature.

[361] CP para 12.121.

[362] We also recommended that LPA 1925 section 53(1)(c), in so far as it applies, be dis-applied. See CR draft reg 10(5).

[363] Nothing discussed in this section will affect charges over financial collateral, for which there is a separate and different requirement of writing derived from the FCAR 2003: see below, para 5.77.

[364] Under current law an RoT clause does not amount to a charge over the goods supplied themselves. The supplier must show that the clause was part of the contract of the sale and identify the goods supplied; but the clause is effective without registration, even if it applies to 'all monies' rather than just to the price of the goods in question. This would remain the case under the scheme we now propose.

[365] See CP 164 paras 6.19-6.20.

be affected,[366] but if the buyer wished to arrange a new source of finance the incoming financier would want to ensure that it would have priority over the supplier's charge over stock or proceeds.

3.305 We are told that this has not proved to be a problem in either the US or Canada.[367] However, in order to re-assure stocking and receivables financiers, we wondered whether the charge should be unenforceable unless it is evidenced by writing signed by the chargor. We have concluded, however, that a writing requirement is not necessary for this purpose. First, a supplier who has taken a charge is entitled to file in relation to that charge, but it is only entitled to file in respect of future transactions if the debtor has consented. If it has no reasonable excuse for filing when the debtor has not consented, it will be liable for any loss it thereby causes the debtor; and if it is shown to have filed without an honest belief in the debtor's consent it may incur a criminal penalty.[368] Thus suppliers who want to file to cover 'extended' RoT clauses in future transactions would be well advised to obtain the buyer's specific agreement to the filing. That would be far more effective in making sure the buyer is aware of the charge than a mere requirement of writing.[369] Secondly, if a filing is made the buyer will receive a verification statement. This will act as a warning to check the terms on which the goods are being supplied. If they include a charge that might affect its ability to raise finance in the future the buyer should insist that this be removed before ordering further goods.

3.306 **We recommend that for charges over collateral (other than financial collateral)[370] there should be no requirement that the charge agreement be in writing**.[371]

[366] Because priority will depend on date of filing: see draft reg 24.

[367] We are told that the numbers of RoT suppliers who file for such extended security are low and they are normally willing to concede priority to an incoming financier, since they lose nothing by allowing an existing financier who has priority to be replaced by another with the same priority.

[368] See above, para 3.91.

[369] A requirement that the charge agreement be in a signed writing would not necessarily prevent the buyer from agreeing to a charge unwittingly, as a buyer may sign a document that includes a charge in favour of the supplier without having read the clauses or understood their effect.

[370] As to this see para 5.77 below.

[371] However we see no reason to remove the current requirement imposed by Law of Property Act 1925 s 53(1)(c), since we received no evidence that it has given rise to problems. (In financial collateral arrangements it is disapplied by FCAR reg 4(2).)

PART 4
SALES OF RECEIVABLES

INTRODUCTION

4.1 For many companies, a major part of their assets will be in the form of money due to them under contracts, particularly for goods or services supplied.[1] This type of asset in known by a variety of names. Traditionally English law has referred to 'book debts'. The UCC talks of 'accounts', which was the term we adopted in the CR. Here we use the more common commercial term, and refer to the monetary obligations owed to a company as 'receivables'. This avoids the legal complexities associated with the term 'book debt';[2] and avoids possible confusion with other forms of account, such as bank accounts and securities accounts. We have, however, used the term 'account debtor' to refer to the person or organisation owing money to the company.

4.2 The term 'receivables' may include any monetary obligation owed to the company. As a major text on the subject explains:

> Mortgage and charge debts, car loans, insurance premiums, credit card debts, secured consumer loans, equipment loans, freights (include sub-freights), rentals from real and personal property, debts for goods sold and services rendered are all receivables.[3]

For our purposes, however, we have included only a narrow range of 'sales of receivables' within the scheme. As we explain below,[4] the scheme we propose will be confined to sales of receivables relating to the supply of goods and services, and will not, for example, cover sales of loan repayments, insurance payments or rent.

4.3 Currently, there are several ways in which a company can raise money on the strength of its receivables. It may take a loan secured by a charge over the receivables. Alternatively, it may sell its receivables outright, for example to a factor, or under a discount arrangement, or as part of a securitisation. Under these sale arrangements the financier advances funds to the company in exchange for an outright assignment of the receivables and recoups them when the receivables are paid. The account debtor may be notified of the assignment

1 See CP 164 paras 6.24-6.32.

2 The Steering Group consultation paper, *Modern Company Law for a Competitive Economy: Registration of Company Charges* URN 00/1213, noted that the meaning of 'book debts' has been the source of constant debate (para 3.34). For further discussion, see CP 164 para 5.45. Under our scheme, this problem disappears. All charges will be included unless specifically exempted (see above, para 3.16), so the distinction between 'book debts' and other debts is no longer relevant.

3 F Oditah, *Legal Aspects of Receivables Financing* (1991) p 2.

4 See below, para 4.27.

so that payment is made direct to the financier, or the company may continue to collect the receivables on the financier's behalf.[5]

4.4 The law currently treats charges over receivables differently from sales of receivables. A floating charge over receivables must be registered, as must a fixed charge over book debts.[6] Outright assignments, however, are not registrable. They do not amount to charges,[7] even if the company agrees to repurchase any receivable that is not paid.[8]

4.5 The normal rule is that priority between competing assignments of receivables depends on the date on which notice was given to the account debtor.[9] The first assignee to notify the account debtor gains priority. However if, when it takes an assignment, a subsequent assignee knows about the first assignment (or has constructive notice of it), it cannot gain priority over an earlier assignment merely by notifying the debtor first. This means that if the earlier assignment is by way of fixed charge and the charge has been registered by the date of the second assignment, its priority will be protected.[10] Conversely an outright assignment cannot be registered, so until the account debtor has been notified, an assignee will be vulnerable to loss of priority to a subsequent assignee (whether outright or by way of fixed charge).

4.6 A further problem with using a receivable as security may arise if the contract under which the receivable arises prohibits assignment. A clause prohibiting assignment does not prevent the assignee acquiring a proprietary right to the debt as against the assignor,[11] but the account debtor is entitled to ignore any notice of assignment and may insist on paying the assignor.[12]

5 This is referred to as 'non-notification' financing, which is typical of block discounting and securitisations: see CP 164 para 6.35.

6 See respectively Companies Act 1985, s 396(1)(f) and s 396(1)(e). The deposit of a negotiable instrument given to secure the payment of book debts is not registrable as a charge: s 396(2). The extent to which it is practicable for the lender to take a fixed charge must be considered in the light of *National Westminster Bank PLC v Spectrum Plus Ltd* [2005] UKHL 41, [2005] 3 WLR 58.

7 See CP 164 paras 6.34-6.35, which discuss the risk that a loan disguised as a sale will be 're-characterised'.

8 A 'recourse' agreement: see CP 164 para 7.36.

9 *Dearle v Hall* (1828) 3 Russ 1.

10 See R Goode, *Commercial Law* (3rd ed 2004) p 750. Note that if a floating charge or a fixed charge over book debts is not registered within the 21-day period it will be void against other creditors: Companies Act 1985, s 395. If a floating charge is registered, whether a subsequent assignee takes free of it depends on whether the charge contains a prohibition on the company disposing of its receivables. If it does and the subsequent assignee has notice of the prohibition, the floating charge will have priority over the subsequent assignment. We understand that, in practice, a factor or other receivables financier approached by a company that has created a floating charge will usually reach a priority agreement with the floating charge-holder before advancing funds.

11 See R Goode, *Legal Problems of Credit and Security* (3rd ed 2004) paras 3.41-3.43.

12 See *Helstan Securities Ltd v Hertfordshire County Council* [1978] 3 All ER 262, QBD; *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] 1 AC 85, HL. It also enables the account debtor to continue to rely on set-offs against the assignor that arise after the debtor has received notice of the assignment.

REGISTRATION AND PRIORITY OF SALES OF RECEIVABLES

Our proposals on consultation

4.7 In the CP we argued that in functional terms a sale of receivables is very much like a charge over them. This is particularly noticeable where the debt is sold on a recourse basis, so that if the debtor fails to pay, the seller must repurchase the debt or make good the loss. However, even for receivables sold on non-recourse basis, a similar effect may be achieved through warranties given by the assignor.[13] As sales of receivables do not have to be registered, potential creditors, investors and purchasers will not know that the receivables do not belong to the company, in the absence of information from the company itself. They will not therefore be alerted to the existence of what is very like security over the company's assets.[14] We thought that sales of receivables should be registrable, as they are under Article 9 of the UCC and all the PPSAs, and asked consultees if they agreed.[15]

4.8 We also argued that the rules of priority over receivables are unsuited to modern conditions. As we saw earlier, under the present law priority between competing assignments of receivables depends primarily on the date of notice to the account debtor.[16] Making enquiries of and giving notice to large numbers of small debtors is expensive and administratively burdensome. Often financiers do not contact debtors, with the result that they may not find out about a previous assignment. They also run the risk that a subsequent assignee will gain priority over them by giving notice. We proposed that sales of receivables should be made registrable, so that priority would normally depend on the date when the relevant financing statement was filed. It would thus be easy for a financier to see whether the debtor company had already assigned its debts. Equally, the financier could file a financing statement itself and secure priority for the future. We pointed out that under the notice-filing system it would be possible for the factor or discount house to file a single financing statement for a series of transactions.[17]

4.9 These provisional proposals were made in the context of our general proposal to adopt a functional approach, so that 'quasi-securities' in general would become registrable. Many consultees supported bringing quasi-security generally into the scheme, but even among those who opposed the inclusion of title-retention

[13] As the Crowther Report pointed out, a sale without recourse may contain warranties by the assignor 'designed to ensure so far as possible that the receivables assigned are not only legally enforceable but likely to be paid. Since breach of these warranties may entitle the assignee to recover his loss from the assignor the distinction between sales with recourse and sales without recourse is not as clear cut as it might appear': Crowther Report Appendix III, para 5.

[14] CP 164 para 7.8.

[15] CP 164 para 7.45. We suggested an exception for book debts sold as part of a larger transaction (such as the overall sale of the business); and that there should be an exception where negotiable instruments are delivered to the receivables financier. Current law provides that the deposit of a negotiable instrument to secure payment of book debts is not to be treated as a charge over those book debts: Companies Act 1985, s 396(2).

[16] Above, para 4.5.

[17] CP 164 para 7.43.

devices there was some support for registering sales of receivables, at least for the purposes of establishing priority.[18]

4.10 The scheme proposed in the CR therefore included outright sales of receivables, so that these would normally have to registered in order to be effective in the company's insolvency. Priority would normally depend on the date of filing.[19]

4.11 Finally, we proposed that the regulations should explicitly preserve the rule that an account debtor who has not been notified of an assignment and pays the assignor will receive a good discharge, whereas one who has been notified will not.[20]

Reactions to the CR recommendations

Priority

4.12 In the responses to the CR the majority[21] supported bringing sales of receivables within the scheme at least for purposes of priority. In particular the trade body for the factoring and discounting industry, the Factors and Discounters Association (FDA), were strongly in favour of this.

4.13 Other bodies were cautious. For example, the Financial Law Committee of the City of London Law Society (CLLS) initially indicated that there may be some merit in bringing in sales of receivables for purposes of priority. After some discussion of alternative schemes, however, they sent a further response arguing that no change should be made at all. [22]

4.14 The CLLS Committee thought that the rules for priority purpose should be the same as those governing when an account debtor will be discharged if it pays the assignee. In other words, the party who notifies the account debtor first will be both the one entitled to payment and the one who has priority. We see the logic of this, but it does not help a prospective financier who wants to be sure that the receivables offered are unencumbered.[23] At present the only way to check is to contact each account debtor, which is frequently impractical. Under the scheme we propose, the financier will simply search the Company Security Register. Any assignments that have not been registered before its own (and it can file in advance in order to safeguard its priority) will not affect it. We understand that

[18] See CR para 2.87.

[19] See CR para 2.88. The scheme of remedies in Part 5 of the CR draft regs, and in particular the rule that any surplus must be paid to the debtor, would not have applied to sales of receivables, which were treated as 'deemed' rather than 'in-substance' security interests: see CR paras 3.44-3.45. On prohibitions against assignment see below, paras 4.35-4.40.

[20] See CR draft regs 45(3) and (4). Nor did we intend to change the rule about set-offs, see note 12 above.

[21] We believe this to be the case although the responses are not easy to interpret, because a good number of them did not express a clear view on sales of receivables as opposed to other forms of quasi-security.

[22] In May 2005, after they had received from us a paper outlining the scheme that Law Commissioners had asked the Team to develop.

this is why there is such strong support of our proposals within the receivables financing industry.

4.15 The Financial Markets Law Committee (FMLC) expressed concern that an assignee might fail to file but might notify the account debtor, who would duly pay it. Under our scheme, another assignee may have priority because it has filed first though it has not notified the account debtor. They thought this could give rise to uncertainty. We think the scenario is unlikely, as most financiers will file as a matter of routine. In any event, similar problems can arise under current law. Giving notice to the account debtor will not secure priority if at the time the second assignment was taken the second assignee had actual or constructive notice of the earlier assignment, yet the account debtor will be discharged by paying the first assignee to notify it. The junior assignee will have to pay the proceeds over to the senior assignee. Similarly, where receivables have been assigned without notifying account debtors, account debtors will be discharged by paying the assignor, who must account to the assignee.

4.16 The CLLS Financial Law Committee were also concerned that some assignees would fail to search the register:

> In some cases (such as financing transactions), an assignee of receivables is likely to search the register, but many types of assignee (particularly in commercial transactions) would not do so. Under the proposed law, they would be adversely affected by not doing so.

We do not wish to affect sales of receivables that do not have a financing purpose. As we explain below, the definition of receivables in the regulations is a narrow one,[24] and we have added a further exclusion for receivables sold on a 'one off' basis.[25] The draft regulations also contain a list of exceptions where, for example, the transferee is to perform the company's obligations, the whole business is being sold or the sale is made purely to facilitate debt collection.[26] Only those involved in receivables financing will be covered by our scheme, and we think they will soon adjust to the new law. It will be simpler to use than the current law, as it will be easier to search and file than to contact account debtors.

4.17 We think that there is a clear case for modernising the priority rules relating to sales of receivables and that priority should be determined by the date of filing.

[23] It is relatively rare for a company to attempt to factor the same debt twice. However, there may well be conflicts between different forms of lender attempting to use the same receivable as security. A factor, a floating charge-holder and a trade supplier with a registered retention of title clause over proceeds may all lay claim to the same receivable.

[24] Para 4.26-4.29.

[25] Para 4.32-4.34.

[26] Draft reg 4(1)(b)-(e).

4.18 **We recommend that the priority of sales of receivables by companies should depend on the date of registration of the financing statement relating to the sale in the Company Security Register**.[27]

Perfection

4.19 The question whether a sale of receivables that has not been registered should be effective in the event of the selling company's insolvency – in other words, whether filing should be necessary to 'perfect' the sale – is more controversial. Some respondents, including the CLLS Financial Law Committee, told us that registration should not be required for perfection. Others support it. It is significant that the FDA's formal responses have consistently supported this proposal.

4.20 The point was made that, in a 'post-Enron' world, there are increasing moves towards disclosure of such transactions in some form. We consider that in the modern world, where receivables form such an important part of the assets of many companies, there is a strong public interest in the publicity that would be provided by registration. In our view it is illogical to require that a charge over book debts be registered publicly but not to require it for a sale of the same debts.

4.21 Three arguments were made against requiring registration as a matter of perfection. Some companies may prefer to keep the fact that they have sold their receivables secret. However, in practice it is difficult to ensure confidentiality of transactions. For example, what is often termed 'confidential' invoice discounting is usually confidential only in the sense that the account debtor is not informed of the assignment. It does not necessarily mean that there is no public record of it. The discounter will often take a charge over the company's receivables to ensure its priority. The charge has to be registered.

4.22 A second argument against requiring registration to perfect the sale is simply that it adds to the burden on the receivables financier. However, this is not likely to be significant. First, many would wish to register to preserve their priority and, as just indicated, may already register a charge even though strictly it may not be necessary. Secondly, filing will be inexpensive and easy, particularly as it will be sufficient to file only once against each company with which the financier deals.

4.23 A more telling argument that was made against the relevant draft regulations in the CR was that the definition of 'account' was very wide. It included any monetary obligation, except those evidenced by an instrument, bank accounts, investment property or loan repayments (other than credit card payments, which were within the scheme).[28] Such a broad definition might cause uncertainty, and, it was said, to impose registration so widely might interfere with securitisations. We accept these criticisms. As we explain in the next section, we now recommend that the definition of receivable in our scheme should be confined to the types of receivable commonly included in factoring or discounting agreements.

[27] Draft reg 24.

[28] CR draft reg 2(1).

4.24 With the restriction just mentioned, we think the balance of advantage is clearly in favour of requiring registration of sales of receivables if the sale is to be effective in the event of the selling company's insolvency, as well as for priority.

4.25 **We recommend that the sale of a receivable by a company should not be effective against an administrator or liquidator of the company unless it has been registered by the onset of insolvency**.[29]

The definition of 'receivable'

4.26 As just mentioned, the CR used a broad definition of an 'account' (which we now refer to as a 'receivable'), taken from the Revised Article 9 of the UCC. Previously, the UCC had used a much narrower definition, but it had been expanded because securitisers in the US wanted all the types of monetary obligations commonly securitised to be included. After discussions with experts on English securitisations, we understand that in the US securitisers face legal risks that are not present here. Here the main pressure for change is among those involved in factoring or discounting agreements. We found no wish to extend registration to the broader types of receivable used in securitisations. We have therefore defined 'receivables' more narrowly, in a way that the FDA consider will meet their needs and no more.

4.27 Our definition centres on monetary obligations arising from the supply of goods and services (with the addition of the supply of energy and brokerage fees, which might not otherwise be included). As we discussed in the CR, it does not include repayments for loans.[30] We did not wish to include loan participation agreements or interfere with borrower's right to prohibit the assignment of a loan (see below). It is also worth pointing out that the definition does not include rent, mortgage repayments or sums due under an insurance contract.

4.28 In the CR we asked whether outright sales of promissory notes should be included within the scheme for the purpose of priority only, as they are within Revised Article 9.[31] In other words, even though the sale of a promissory note does not have to registered to be perfected, should its priority date from the moment of the sale? We understand that this is not necessary. Under US law a promissory note is not necessarily a negotiable instrument but under English law it is. We have therefore excluded sales of promissory notes from our proposals.

4.29 **We recommend that the definition of a receivable for the purpose of our scheme should include only a monetary obligation, whether or not it has been earned by performance, arising from goods or services supplied, energy services supplied or brokerage fees.**[32]

[29] See draft reg 20.

[30] CP paras 3.21 and 5.33.

[31] In the language of Article 9, sales of promissory notes are 'automatically perfected': see section 9-309(4).

[32] See draft reg 2(3).

Exceptions

4.30 The draft regulations in the CR excepted from the scheme a number of cases in which the sale of accounts did not have a 'financing purpose'. These exceptions were accepted almost without criticism[33] and we recommend that they apply to the final scheme.

4.31 **We recommend that the following should be exempt from the scheme**:

(1) the assignment of an unearned right to payment under a contract to a person who is to perform the transferor's obligations;[34]

(2) the assignment of receivables solely to facilitate collection on behalf of the person making the assignment;

(3) the assignment of a single receivable to an assignee in full or partial satisfaction of a pre-existing indebtedness; and

(4) the sale of receivables as part of the sale of a business out of which the receivables arose.[35]

Isolated assignments of receivables

4.32 The working group set up by the FMLC suggested that there might be a different rule for assignments of receivables made on a 'one-off' basis, to protect an assignee who did not realise that it should file. In the CR we asked whether we should adopt a rule found in Revised Article 9 of the UCC.[36] Section 9-309 has the effect that an assignment of accounts receivable 'which does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor's outstanding accounts…' does not need to be registered and has priority from the date it is taken.[37] The Official Comments note that the purpose of this provision 'is to save from *ex post facto* invalidation casual or isolated assignments – assignments which no one would think of filing'.[38] The FMLC then expressed concern that the rule might give rise to uncertainty about whether a particular assignment amounted to a significant part of the assignor's outstanding accounts.

4.33 The exemption is designed to prevent 'the assignment which no one would think of filing' from being rendered ineffective even though its absence from the register is highly unlikely to prejudice a subsequent receivables financier or other creditor. We think the relevant test is whether the sale (by itself or in conjunction

[33] The CLLS FLC disagreed with the exception of sale of accounts as part of the sale of a business, arguing that it could have a financing purpose if the sale was part of a whole business securitisation. We cannot envisage a case that would fall within our scheme.

[34] A further reason for this exclusion is that there is no risk of misleading third parties that the transferor retains rights under the contract: see CR para 3.62, note 79.

[35] See draft reg 4(1)(b)-(e).

[36] See CR para 3.97. We did not include the rule in the CR draft regs.

[37] In other words, it will have priority over assignments that are filed later, but be subject to any that have been filed already.

[38] Official Comment 4, which goes on to note that any person regularly taking assignments of any debtor's accounts should file.

with others to the same party) is material to the later financier's or creditor's decision. If not, no harm is done by its non-registration. We can see that in principle there may be litigation about this question, but the rule is not likely to produce any great uncertainty in practice. The assignee of a single receivable who wishes to avoid any possible dispute can do so by filing, whether it needs to or not.

4.34 **We recommend that a sale of receivables does not need to be registered if the sale (by itself or in conjunction with other sales to the buyer) is of such a small proportion of the assignor's receivables that it would not influence a reasonable person deciding whether to make an advance to the company. For priority purposes, it should be treated as if it had been registered on the date of the sale**.[39]

PROHIBITIONS AGAINST ASSIGNMENTS OF RECEIVABLES

4.35 In the CR we considered the current rules on contractual prohibitions on assignment. If a contract provides that the debt may not be assigned without the debtor's consent, this does not prevent the assignee from acquiring a proprietary right to the debt as against the assignor.[40] However, the account debtor is entitled to ignore any notice of assignment and may insist on paying the assignor.[41] This rule is said to be 'inimical to receivables financing, where it is simply not practicable for the assignee (such as the factoring company) to examine individual contracts for assignment clauses'.[42] The FDA told us that 'contractors who would normally use invoice finance facilities as a matter of course but are prevented by such clauses are forced to turn to other, more expensive and less appropriate forms of finance to fill the finance gap'.

4.36 The UCC and the SPPSA contain express provisions that a term in an agreement between an account debtor and an assignor preventing or restricting assignment is ineffective, though without affecting the question of whether the assignment amounts to a breach of contract by the assignor.[43] So do the UNIDROIT Convention on International Factoring[44] and the 2001 UN Convention on the Assignment of Receivables in International Trade.[45]

4.37 We were urged strongly to adopt the same rule. Despite reservations that it would be awkward to have one rule for companies and another for unincorporated

[39] Draft reg 20(2).

[40] See R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) paras 3-41–3.43.

[41] *Ibid*, paras 5-31-5-39. See *Helstan Securities Ltd v Hertfordshire County Council* [1978] 3 All ER 262, QBD; *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] 1 AC 85, HL. It also enables the account debtor to continue to rely on set-offs against the assignor that arise after the debtor has received notice of the assignment.

[42] *Ibid*, para 3-40 at n 11.

[43] SPPSA, s 41(9); UCC section 9-406(d). The OPPSA does not have a similar provision, although this has been criticised: J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 40.5 (pp 334-335).

[44] Art 6(1).

[45] Art 9.

businesses,[46] we provisionally recommended reform. The draft regulations set out in the CR provided that a term in a contract between a company and a third party that purports to prohibit or restrict assignment of the account should be of no effect against a third-party assignee. The 'override' would apply only to prohibitions on assignment of accounts as defined in the draft regulations. Thus clauses in loan agreements, for example, would be unaffected.[47]

4.38 The proposal continued to be controversial. The FDA supported it strongly. The British Bankers Association said that it 'would remove a significant obstacle to receivables financiers – and on that basis we would support it.'[48] Others opposed it. Much of the opposition, however, was based on a misplaced concern that it would apply to loan agreements, or that 'there is no demand for the change'.[49] The latter is simply incorrect: the industry concerned supports the change strongly.

4.39 As we said in the CR, it is obviously true that to prohibit anti-assignment clauses is an interference with freedom of contract. The question, however, is whether the interference is justified. In the light of the responses to the CR we have concluded that, given the inconvenience of the current rule in the context of receivables financing and the international trend towards overriding such prohibitions, the interference is clearly justifiable.

4.40 **We recommend that in a contract between a company and a third party creating a receivable payable to the company, a term that purports to prohibit or restrict assignment of the account should be of no effect against a third-party assignee.**[50]

TERRITORIAL APPLICATION

4.41 In Part 3 we recommended that charges created by Scottish and oversea companies over their assets in England and Wales should be within our scheme. These charges would be registrable and would be subject to the same rules of priority as charges created by companies registered in England and Wales.[51] Here we consider whether sales of receivables by Scottish and oversea companies should also be within the scheme if the receivable is 'situated' in England and Wales. We have concluded that this would not be sensible.

[46] We pointed out that the law on assignment of receivables is already fragmented, as outright sales of receivables by a company do not have to be registered but a general assignment of book debts by an unincorporated business requires registration as a bill of sale: Insolvency Act 1986, s 344; see CP 164 para 8.36. We argued that it is better to make the companies-only scheme as complete as possible, even at the risk of some further fragmentation.

[47] CR para 5.33.

[48] They expressed concern that the proposed rule might cause problems in financial markets with set-off and netting. These issues will not arise now that the scheme's definition of 'receivables' is narrower. See above, para 4.29.

[49] CLLS FLC response of May 2005.

[50] See draft reg 35(5).

[51] See above, paras 3.268 and 3.284`

4.42 There is considerable uncertainty as to the 'situs' of a receivable.[52] It may be that the debt is situated where the account debtor has its business, or in the country whose law governs the contract creating the receivable. In either case, bringing sales of receivables by oversea companies within the scheme might create significant problems for their receivables financiers. A foreign financier buying the receivables of an oversea company might have no practical way of discovering that some of them were situated in England and Wales. Therefore it would not file a financing statement. It would be more likely merely to take whatever steps (if any) were necessary to perfect the sale in the country of the company's incorporation. It would be unfortunate if, in the event of the company's insolvency, it was held that the failure to register left the sale of the English receivable ineffective as against the company's liquidator.[53]

4.43 Nor would other foreign parties dealing with the oversea company normally think to search the Company Security Register to find out about sales of receivables. They would be much more likely to make other forms of enquiry, and to do so in the jurisdiction where the company was registered.

4.44 We think that at least until receivables financiers have become accustomed to the new scheme for registration and priority of receivables, sales by companies registered in Scotland of their 'English' receivables should also be excluded.

4.45 **We recommend that the provisions on sales of receivables should apply only to sales by companies registered in England and Wales**.

TRANSITIONAL ARRANGEMENTS

4.46 We think it is important that the Company Security Register should give a complete picture of a company's position as is practicable. Therefore existing arrangements for the sale of receivables should be registered within a transitional period, failing which they should be subject to the normal sanctions for non-registration.[54]

4.47 It is true that we have recommended that existing charges that are not registrable under current law should not have to be registered.[55] We were told that many lenders would find it very costly to identify what charges they hold, and the cost of finding out would outweigh any benefit to be gained from having more complete information on the register. This does not apply to sales of receivables. Receivables financiers tend to make advances to the company on a regular basis. They should have no difficulty in identifying the customers they do business with and registering a financing statement against each customer within a relatively short period.

[52] See *Dicey & Morris, The Conflict of Laws* (13th ed 2000) paras 24-049–24-058.

[53] In this respect we think sales of receivables are different from charges over them. Requirements to register charges are much more common (particularly when the charge is a floating charge or an 'enterprise charge', which with receivables is likely to be the case). Foreign chargees are therefore more likely to be aware of the need to register charges than to register sales.

[54] Principally, the sale would be ineffective in the event of the company's insolvency: see above, para 3.78.

[55] See above, para 3.290.

4.48 **We recommend that existing agreements to sell receivables should have to be registered within two years of the commencement of the scheme. During the transitional period, an interest arising under an existing agreement should have priority over any conflicting charge or sale entered into after commencement (whether registered or not). An existing sale registered within the transitional period should be treated as if it had been registered at the date of commencement**.[56]

[56] Draft reg 46(5)-(7).

PART 5
FINANCIAL COLLATERAL

INTRODUCTION

5.1 This Part of the report deals with security (charges and pledges) over 'financial collateral'. We use the phrase 'financial collateral' in, broadly speaking, the way it is used in the European Directive on Financial Collateral Arrangements[1] ('the Financial Collateral Directive' or 'FCD') and the Financial Collateral Arrangements (No 2) Regulations 2003[2] ('FCAR') which implement the Directive.

5.2 The FCD provides that when financial collateral subject to a 'security financial collateral arrangement' (that is, a mortgage, charge or pledge) has been 'provided' in such a way as to be in the 'possession or control' of the 'collateral-taker', formalities such as registration cannot be required in order to render the arrangement enforceable.[3]

5.3 The FCD also requires, in outline, that certain remedies must be available (unless otherwise agreed) and remain so notwithstanding winding-up or re-organisation of either party;[4] that agreed rights of use must be available;[5] and the arrangements must be exempted from certain effects of insolvency law.[6] These aspects of the FCD are not affected by the draft Company Security Regulations.[7]

5.4 The FCD and the FCAR apply to various forms of investment securities (termed 'financial instruments') and to 'cash'. It is helpful to explain at the outset what is meant by these terms, as our scheme's provisions on financial collateral apply only to security over these assets and certain other forms of what we call 'investment property'.[8]

Investment securities

5.5 Investment securities such as shares or debt securities[9] fall into three types:[10]

1 Directive 2002/47/EC of the European Parliament and Council of 6 June 2002, OJ L 168/43.

2 SI 2003 No 3226.

3 Art 3; see FCAR reg 4(1). The agreement or arrangement must also be evidenced in writing: see below, para 5.77.

4 Art 4; see FCAR reg 17.

5 Art 5; see FCAR reg 16.

6 Art 8; see FCAR Part 3.

7 Nor are 'title-transfer collateral arrangements', such as 'repos', to which the FCD also applies. See note 23 below.

8 The special provisions on financial collateral are in Part 5 of the draft regulations. The terms used are defined in draft reg 41.

9 These are often called bonds.

10 See further CR paras 4.6-4.11.

(1) certificated bearer securities (such as bearer shares or bearer bonds). These are a form of negotiable instrument, transferable simply by delivery;

(2) certificated, registered securities (for example shares for which the company has issued paper certificates). These are not negotiable. Transfer of the legal title requires that the person acquiring the security is entered as the owner on the issuer's books; and

(3) uncertificated securities, for which no paper certificate is issued. Trades of uncertificated securities issued in the British Isles[11] are settled electronically through the CREST system. The name of the direct holder of the securities is entered on both the CREST ('operator's') and the issuer's registers. For UK companies it is the entry in the operator's register that confers legal title.[12]

5.6 If the investor has possession of a bearer security, or if the investor is shown on the issuer's or on the CREST register as being entitled to the securities, it holds 'directly'. Alternatively, any of the securities may be held by the investor 'indirectly', for instance where a stockbroker or other intermediary holds shares for an investor whose entitlement is recorded on the books of the intermediary. (The FCD refers to indirect holdings as 'book entry securities'.)[13] There will be an indirect holding where, for example,

(1) the physical certificates for shares are 'immobilised' by being deposited with a custodian, and the intermediary with which the investor has its account holds the shares through the custodian, or through the intermediary directly above it in the chain; or

(2) the intermediary is registered as the holder of an uncertificated security but holds for the person (the investor or a lower-tier intermediary) shown in its books as the account holder.

5.7 Each kind of directly-held investment securities, and indirectly-held investment securities, are dealt with in the draft regulations in Appendix A to this report.[14] Different provisions apply to each type, because the practical methods by which a chargee may obtain 'control' over each type differ. We will see below that in our scheme directly-held securities are termed 'financial instruments', whereas indirectly-held securities come within the phrase 'financial assets held with an intermediary'.

[11] That is, in the UK, Republic of Ireland, Isle of Man, Guernsey and Jersey. As a result of the links that CREST has developed with overseas central securities depositaries, CREST now also offers settlement in a wide range of international securities.

[12] Uncertificated Securities Regulations 2001, SI 2001 No 3755 (USR), reg 24(6). For Irish, Manx, Guernsey and Jersey securities, the pre-2001 system still operates. Settlement is through CREST but legal title is transferred when the entry is made in the issuer's register.

[13] Art 2(1).

[14] See for example draft reg 40, which sets out when a chargee will have 'control' over each type of holding. The significance of 'control' is explained below.

'Cash'

5.8 In this context cash does not have its everyday meaning of hard currency. It is defined as 'money in any currency, credited to an account, or a similar claim for repayment of money and includes money market deposits'.[15] Thus a typical form of cash is a bank account.

Other forms of investment property

5.9 The scheme also applies to other forms of 'financial asset' that are held through an intermediary. An example is rights under a commodity futures contract, a commodity futures option or other similar contract. Financial assets held with an intermediary and financial instruments are termed collectively 'investment property'.

GENERAL OBJECTIVES

5.10 As we said in the CR:

> Shares and other forms of investment property are of enormous importance as collateral. Convenient and legally robust financial collateral arrangements are crucial to the effective functioning of the wholesale financial system. Companies have very large holdings of various kinds of investment property and need to be able to use them as security, and to do so with confidence that the legal position will reflect accurately proper commercial practices and reasonable commercial expectations. In particular the law must accommodate the fact that much investment property is now held in dematerialised form. The law should make it clear how lenders may take security and, where there is a contest between different SIs [security interests] or other interests over the same assets, what the rules of priority are. At the same time the law must not hinder trading in investment securities. Thus there must be ready mechanisms that suit the needs of the various parties:
>
> (1) secured parties should be able to take effective security without the need to file;
>
> (2) both potential secured parties and potential buyers should be able to take security over/buy the collateral without the need to search, confident that they will not be subject to SIs of which they are not aware; and
>
> (3) debtors (so far as compatible with the relevant settlement systems) should be able to continue to deal with the investment securities.[16]

5.11 Consultees supported these general objectives strongly.

[15] FCD art 2(1)(d), to which FCAR reg 3 adds 'sums due or payable to, or received between the parties in connection with the operation of a close-out netting provision'.

[16] CR para 2.140.

OUR PROPOSALS ON CONSULTATION

The proposals

5.12 In CP 164 we explained that Revised Article 9 of the UCC provides a special method of perfecting charges over securities and bank accounts. This is particularly to deal with charges over securities and other investment property held indirectly. The secured party may perfect by taking 'control' of the debtor's securities entitlement.[17] A similar approach is applied to security over bank accounts.[18] We pointed out that the (then) proposed directive on financial collateral was likely to prevent national laws from requiring registration of charges over such 'financial collateral' that is 'in the possession or under the control of' the secured party.[19] We provisionally proposed that we should apply the same rules to charges over bank accounts and shares, but asked whether control should be the only method of perfection in both cases.[20]

5.13 The responses to CP 164 and subsequent discussion suggested that there was quite wide support for bringing charges over investment property and bank accounts within our scheme but permitting 'perfection' by control or by registration as alternatives. Therefore in the CR we developed a scheme based on Articles 8 and 9 of the UCC and proposals for similar reform in Canada.[21] The scheme was intended to be compatible with the Financial Collateral Directive, which by then had been adopted and implemented by the FCAR. It sought to define what amounts to 'control' for the purposes of the FCAR (which gives only a partial definition); and to provide clear rules on the priority of charges between themselves and as against innocent purchasers of the property in question.

Responses to the CR scheme

5.14 Of those who commented on the issue, a large number (including the Financial Law Committee of the City of London Law Society and thus, by implication, those who adopted the Committee's paper) supported our attempt to define 'control' for the purposes of the FCAR.

5.15 There were, however, a number of criticisms directed to particular issues. Some were directed at the proposed statement of rights and remedies.[22] Another concern was that 'title transfer financial collateral arrangements' such as 'repos'

[17] CP 164 para 5.24.

[18] *Ibid* para 5.52.

[19] *Ibid* para 5.26.

[20] UCC article 9 permits perfection of security interests over investment property by either method but over bank accounts only by control.

[21] See CR para 4.2.

[22] This would have applied to security interests in financial collateral, though with the qualification that the 'right of appropriation' which is guaranteed by the FCD would not be affected. It was said that the rules would impede the market, in particular by requiring that notice be given to a defaulting debtor before financial collateral could be sold.

might be caught by the scheme.[23] As we are no longer recommending that a statement of rights and remedies be included in the companies-only scheme, the issue becomes at least temporarily moot.[24] Similarly, as we are no longer recommending that the companies-only scheme should contain a broad definition of a security interest that would include title-retention quasi-securities,[25] there is no reason to bring title transfer financial collateral arrangements within the scheme.

5.16 Other points made by respondents remain very relevant; for example, that we had not covered every aspect of the CREST system for settlement of uncertificated securities;[26] that the test we were proposing for 'control' over bank accounts was unnecessarily demanding;[27] that we had dealt only with bank accounts and not other forms of 'cash';[28] and that commodity contracts were not treated adequately.[29] We accept these criticisms. Below we set out our detailed recommendations, and we explain how we have revised the draft regulations to meet the points made.

Further analysis

5.17 Other aspects of our scheme received very positive support, in particular our aim of providing a definition of 'control' for the purposes of the FCAR and our recommendations for control over investment property. However, our own further work has led to some changes in these recommendations.[30] The scheme we now recommend is less ambitious than that envisaged by the CR. Nonetheless we have managed to keep its essential features, so that the draft regulations and our report will provide those taking financial collateral with clearer guidance on what steps should be taken if a charge is to be effective in the debtor's insolvency. They will also provide clearer rules on the priority of a charge as against another charge or the interests of a person who has bought the financial collateral.

5.18 We have also aligned the terminology of the draft regulations with the terminology of the FCAR and the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary. For example, the regulations now refer to 'financial instruments' rather than 'securities' and to 'assets held with

[23] 'Repos' (or more fully, sale and repurchase arrangements) are transactions that can perform a similar economic function to charges but take a different legal form, which under current law does not amount to the giving of a security. The seller (in effect the 'borrower') sells investment property to the 'lender' and agrees to buy equivalent securities back at a future date at the original price plus a financing charge. See CP 164 paras 6.38-6.45; also R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 6-18.

[24] For possible further work on a restatement of security law, see above, para 1.70.

[25] See above, para 1.29.

[26] See further below, para 5.73.

[27] See below, para 5.48.

[28] See below, para 5.33.

[29] See below, para 5.30.

[30] See below, paras 5.42-5.68.

an intermediary' rather than 'securities entitlements'.[31] This will make the regulations easier to understand by those familiar with the other instruments.

SUMMARY OF OUR RECOMMENDATIONS ON SECURITY OVER FINANCIAL COLLATERAL

5.19 The special provisions we recommend for financial collateral have three principal aims:

(1) to clarify, so far as possible, when a charge over financial collateral does not need to be registered in order to be effective in the debtor company's insolvency (broadly speaking, this will be when the chargee has 'control' of the collateral);

(2) to establish clear rules of priority for competing charges over financial collateral (which depend largely on whether, and at what date, the chargee obtained 'control'); and

(3) to provide clear rules on when a purchaser of investment property who did not know of a charge over it, or that the disposition was in breach of that charge, will take free of it.

5.20 The scheme may be summarised as follows:

(1) A charge over a company's financial collateral will be effective in the company's insolvency if the chargee has obtained control (as defined in our draft regulations) or has 'possession or control' of it within the meaning of the FCAR; or if the charge has been registered.

(2) The regulations set out the methods by which the chargee may obtain 'control' over different types of financial collateral, and also provide a general test of 'control' to cover situations not currently envisaged. The basic principle, which is reflected in the general test, is that the chargee will have control if the debtor company is no longer able to dispose of the collateral free of the chargee's interest or so as to give a purchaser an interest ranking in priority to that of the chargee. In addition, and in each case set out below, the arrangement must be evidenced in writing (as required by the FCAR).

(3) A chargee may obtain 'control' within the meaning of the regulations in the following ways:

(a) with certificated financial instruments in registered form,

(i) by taking possession of the certificate, or

(ii) by being registered as the holder;

(b) with directly-held uncertificated financial instruments, if

[31] See below, paras 5.36-5.41.

(i) the operator of the system, on the instructions of the registered holder, has credited the financial instrument to a sub-account in the holder's own name but the holder has given the chargee a power of attorney over the financial instrument,

(ii) the operator of the system is only permitted to effect a transfer of title to the financial instrument on the instructions of the chargee or a person acting on the chargee's behalf and attributable to the debtor, or

(iii) if the chargee is entered in the relevant register as the holder;

(c) if the debtor's interest is in financial assets held with an intermediary:

(i) if the assets are transferred to an account held by the chargee,

(ii) if the intermediary has been given notice of the assignment by way of mortgage or of a fixed charge, or, where necessary, has agreed that the debtor will no longer be able to deal with the collateral without the agreement of the chargee; or

(iii) if the chargee is itself the debtor's intermediary.

(4) With certificated financial instruments in bearer form, a secured party (who in this case will be a pledgee) will have control if it has obtained possession of the certificate.

(5) With a bank account or other forms of 'cash' within the meaning of the regulations, a chargee will have control:

(a) where the chargee is the bank or other 'cash debtor' itself, without more; or

(b) where the chargee is a third party,

(i) if the bank or other cash debtor has been given notice of the assignment by way of mortgage or of a fixed charge, or, where necessary, has agreed that the debtor will no longer be able to deal with the collateral without the agreement of the chargee; or

(ii) if with the agreement of the parties the 'cash' is transferred into the chargee's name.

(6) As between competing charges over the same financial collateral, a chargee who has obtained control will take priority over a chargee who does not have control, whether or not it had given value and whether or not it knew of the prior interest. If both chargees have obtained control, priority will (unless agreed otherwise) be in the order that they obtained control. This would be without prejudice to the rights of purchasers of investment property, below.

(7) A purchaser (including a mortgagee) who gives value for investment property and who does not know that the disposition to it is in breach of the terms of a charge will take free of the charge if:

(a) in the case of a certificated financial instrument in registered form or an uncertificated financial instrument, the purchaser is registered as the holder, or

(b) in the case of a financial asset held with an intermediary, the financial asset is transferred into an account in its name.

SCOPE OF THE PROVISIONS ON FINANCIAL COLLATERAL

5.21 The provisions on financial collateral apply to 'financial instruments', 'cash' and other forms of 'investment property' held with an intermediary.

'Financial instruments'

5.22 In our scheme, 'financial instruments' refer to directly-held securities. The draft regulations use the term 'financial instruments', rather than 'securities', to align the terminology of the scheme with the FCAR.

5.23 The CR used 'security' (in the singular)[32] and included a definition derived from the UCC.[33] There were concerns that it might not cover the same range of investment property as is within the definition of 'financial instrument' in FCAR.[34] In particular, there were doubts whether it would cover uncertificated 'eligible debt securities' and warrants entitling the holder to acquire shares.[35] It was also said that units in collective investment schemes and depository interests were not necessarily 'interests in the property … of an issuer', because of pooling. The scope of our provisions should match that of the FCAR and therefore the definition should be the same.[36]

[32] We were also asked to use the plural 'securities' rather than the singular 'security' to avoid any possible confusion with 'security' in the sense of taking security. Our recommendation to refer to 'financial instruments' makes the point moot.

[33] Section 8-102(15).

[34] FCAR reg 3.

[35] CREST response, p 4; CLLS FLC para 6.26.

[36] We had followed the UCC model because of our general policy to have a scheme that resembled the North American models unless there was a reason to differ. We had said that we could adopt the FCAR definition if that was thought preferable, as it seemed to us to cover the same ground: CR para 4.32. In fact there are two differences which must be recognised: see below, para 5.25.

5.24 We think that if we are to follow the FCAR model, there would be an advantage in following it as closely as possible. This is why in the draft regulations we have replaced the word 'securities' with 'financial instruments'. Although it may at first seem a little odd to refer to 'certificated' and 'uncertificated financial instruments', 'certificated financial instruments in bearer form' and so on, those we consulted told us that they would have no objection and favoured the resulting consistency with the FCAR.

5.25 The definition of 'financial instruments' in the regulations that we recommend in this report differs from the FCAR's definition of 'financial instruments' in two respects. First, it excludes indirectly-held securities.[37] This is because under our scheme these, together with other forms of investment property that is held on the books of an intermediary, have to be distinguished from directly-held financial instruments because the tests for control over the various types of asset differ. Indirectly-held securities are covered by the more widely defined 'financial assets.' Secondly, it has a provision to include depository instruments and the like held in CREST.

5.26 'International'[38] securities may be held through CREST, if the relevant securities can be held in a settlement system with which CREST has a link. A CREST subsidiary (through a CREST nominee in the other settlement system) holds the underlying security. A CREST Depository Instrument (CDI) is issued. It was pointed out that this is constituted under English law as an uncertificated security.[39] There may be other assets besides CDIs that should be treated similarly. Words have therefore been added to the draft regulations to ensure that any securities held in CREST are treated as directly-held securities.

5.27 **We recommend that the regulations refer to 'financial instruments', reflecting the definition of 'financial instruments' in the FCAR with the qualifications that:**

(1) the definition should apply only to directly-held financial instruments, since indirect holdings are treated differently and are covered by other definitions, and

(2) the definition should include CREST Depository Instruments and similar assets that are constituted as uncertificated securities.[40]

Indirectly-held securities and other forms of investment property

5.28 The provisions on financial collateral apply to indirectly-held securities, and also to any other financial assets[41] that are held with an intermediary.[42]

[37] Thus the words 'claims relating to or rights in or in respect of any of the securities included in this definition', found in FCAR reg 3, are omitted.

[38] That is, securities not issues by a UK, Irish, Manx, Jersey or Guernsey company.

[39] CREST response p 8. The relevant statutory provisions are Uncertificated Securities Regulations 2001 (SI 2001 No 3755) regs 22(3) and 24(7).

[40] See draft reg 41.

[41] Defined in draft reg 41.

5.29 Examples of financial assets that may not fall within the FCAR definitions of financial instruments or 'cash', but are within our scheme if they are held through an intermediary, are rights under commodity contracts (a commodity futures contract, a commodity futures option or a similar contract). These may be held in an account by a commodities broker or other intermediary and may be used as collateral in much the same way as other financial assets. In practice such rights normally represent a right to payment of differences and are thus roughly equivalent to 'cash' held in an account, though they may not fall within the FCD.

5.30 The draft regulations in the CR dealt with commodity rights in separate provisions, but this was merely because doing so made it easier to compare the draft regulations on financial collateral with the provisions of the UCC, which deals with commodity contracts separately. We reported that the UCC does so only because in the United States commodities and securities are subject to a different regulatory scheme. We suggested that in our scheme the two types of collateral could be covered by the same provisions.[43] Consultees agreed and commodity contracts now come within the definition of financial asset. Thus a charge over rights represented by an entry in the accounts of an intermediary may be perfected by taking control, and the same priority rules will apply as with cash.

5.31 It is conceivable that an intermediary might carry on its books not just rights under commodities futures contracts but rights to a commodity itself, for example bullion that is held by the intermediary in its own name. The definition of financial assets is wide enough to cover this possibility. [44]

5.32 **We recommend that rights under commodity contracts and to commodities held with an intermediary should be treated in the same way as other financial collateral.**[45]

'Cash'

5.33 The regulations refer to 'cash', which includes money in a bank account, whereas the draft regulations in the CR applied only to bank accounts. It was pointed out that the FCAR apply not only to money that is 'credited to an account' but also to any 'similar claim for money and includes money market deposits and sums due or payable to, or received between [the parties] in connection with the operation

[42] These together with financial instruments, are 'investment property'. Thus the 'residual' test of whether a chargee has 'control' applies to 'collateral consisting of investment property or cash': see draft reg 40(9).

[43] See CR paras 4.88-4.92.

[44] This would not affect, for example, the London Metal Exhange's SWORD system, under which warrants may be pledged by attornment rather than by physical delivery. SWORD participants are able to lodge warehouse warrants over specific lots of metal in an electronic register. The register is maintained by a depositary, appointed by LME, which holds the warrants as bailee for the account-holders. The warrants are pledged by the pledgor issuing an electronic 'ex-cleared transfer instruction' to transfer the warrant to the pledgee's account. The pledgee is notified of the transfer instruction. Constructive delivery by attornment is then completed by the pledgee issuing an acceptance instruction and the depositary crediting the warrant to the pledgee's account. Under our revised scheme, this will simply be a pledge.

[45] See draft reg 41 "financial asset".

of a financial collateral arrangement or a close-out netting provision.'[46] Apparently such sums will not necessarily be credited to an account. We agree that they should be included within the scheme for financial collateral, and we recommend that the relevant provisions of our scheme should apply to 'cash' as defined in the FCAR. It is true that the FCAR definition is somewhat counter-intuitive, as the things that most uninitiated readers will think of as quintessential cash – currency and (possibly) cheques – are not within it.[47] However we think that almost all readers of the relevant parts of our regulations are likely to be familiar with the technical meaning under the FCAR.

5.34 Therefore the special provisions for financial collateral in our scheme will, like the FCAR, apply to 'financial instruments' and 'cash'.[48] The bank or other person who owes the cash is referred to as the 'cash debtor'.[49]

5.35 **We recommend that the rules on control over financial collateral should apply to bank accounts and all other forms of 'cash' within the meaning of the FCAR.**[50]

TERMINOLOGY AND DEFINITIONS

5.36 We have already referred to many of the definitions of different types of financial collateral in explaining the scope of the provisions on financial collateral: 'cash', 'cash debtor', 'certificated' and 'uncertificated financial instruments', 'financial asset' and 'investment property'.

5.37 The terminology of the draft regulations relating to indirectly-held investment property has been altered to reflect the FCAR and the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary. By contrast, the terms used in the CR derived from revised Article 9 of the UCC. It was put to us that, since we are departing from the North American model in any event, it would be better to adopt the terminology that is more widely accepted in Europe. The terminology and the definitions used in the Hague Convention are particularly apt.[51] We agree, subject to necessary adjustments being made to take account of the wider scope of our scheme.

5.38 Thus the new draft regulations refer to:

(1) an 'intermediary' in place of a 'securities intermediary';

[46] FCAR reg 3 ('cash').

[47] Recital 18 of the FCD states that banknotes are 'explicitly' excluded.

[48] And to other indirectly held financial assets: see above, para 5.32.

[49] Draft reg 41. This resolves a problem with the CR draft regs, which applied separate rules to bank accounts. They provided a definition of a bank that did not apply to overseas banks although charges over funds in an account at an overseas bank would be within the scheme.

[50] See draft regs 36, 39 and 40.

[51] For example, the latter's definition of what we termed an 'entitlement holder' were carefully crafted to fit with the varying ways in which different legal systems view the rights of the holder.

(2) 'financial assets held with an intermediary' in place of the former 'securities entitlement'; and

(3) 'account holder' in place of 'entitlement holder'.

'Securities account' is retained but is now defined in terms that mirror those of the Hague Convention.[52]

5.39 It was also pointed out that some of the provisions of the CR draft regulations referred to a 'securities account' as if it were an asset in its own right, rather than a record of the account holder's entitlement. On the other hand it is convenient to speak of a securities account as a way of designating the financial assets in the account.[53] The new draft regulations do not list 'securities accounts' as a separate item of property but a control agreement in respect of financial assets held with an intermediary may refer to the particular assets or to the account in which they are held.[54]

5.40 There was concern that the definition of 'securities intermediary' in the CR draft regulations was too wide and might catch not just intermediaries but also CREST. This is not the intention since there will be separate rules for control in the CREST system (which involves only directly-held securities) and for indirectly-held securities. The new draft regulations therefore adopt the FCAR's definition of 'intermediary', which we were told was drafted by Treasury Counsel in the light of article 5 of the Hague Convention. This allows Contracting States to declare that operators such as CREST are not intermediaries for the purpose of the Convention.[55]

5.41 **We recommend that the regulations should use terminology that reflects that of the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary and the FCAR. They should refer to 'financial assets held with an intermediary' and 'account holder' and should define 'securities account' and 'intermediary' in ways that fit with the Convention and the FCAR.**[56]

'CONTROL' OF FINANCIAL COLLATERAL AND EXEMPTION FROM REGISTRATION

5.42 A charge under which the chargee has 'possession or control' under the FCAR is exempted from any registration requirement under section 395 of the Companies

[52] It was pointed out that the CR definition, 'an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that constitute that financial asset' would not necessarily reflect the arrangements made, for example if the account-holder had agreed that the operation of the account should be under the control of a third party such as an investment manager.

[53] It appears that an intermediary may maintain a number of separate accounts for a single client.

[54] See draft reg 40(10), which deals with the priority over collateral that is later credited to the account.

[55] The definition of 'intermediary' in art 1(1)(c) includes operators of settlement systems.

[56] See draft reg 41.

Act 1985.[57] Neither the FCD not the FCAR provide a precise definition of what amounts to 'possession and control' of financial collateral. Our aim in the CR was to provide a definition of what should amount to 'control' within the meaning of the FCAR, and clear rules to govern the priority of competing interests over financial collateral. The scheme that we provisionally recommended was based on the North American models. It applied a similar test of 'control' to both investments and bank accounts. On the one hand the secured party was treated as having sufficient 'control' to perfect its security interest if it had taken all the steps that it reasonably could to give itself the right to realise the collateral, or to appropriate it in order to satisfy the secured obligation, without any further act on the part of the debtor or any court order.[58] On the other hand, in the cases of investments held with an intermediary and with bank accounts, the secured party who had obtained the right to realise the collateral would have control even though the debtor retained the right to deal with the collateral.

5.43 Thus for investment property the draft regulations in the CR provided:

> an… intermediary enters into a control agreement with a purchaser if, with the consent of the entitlement holder, it agrees with the purchaser to comply with the purchaser's instructions directing the transfer or redemption of the property in question without further consent from the entitlement holder, whether or not the entitlement holder retains the right to deal with the entitlement.[59]

5.44 For reasons we will explain, comments from consultees combined with our own further analysis have convinced us, first, that the test of 'control' suggested in the CR is not compatible with the FCD and, secondly, that it is not possible to provide a definition of 'possession or control' for the purposes of the FCAR. We are able, however, to provide clear guidance on when a charge does not need to be registered. It will not need to be registered if the chargee has obtained 'control' within the meaning set out in the regulations.

5.45 The issues are complex and require explanation in some detail. We begin by considering the possible meanings of 'control'.

Forms of 'control'

Positive control versus negative control

5.46 A chargee who has secured the agreement of the intermediary to comply with the chargee's instructions without further consent from the entitlement holder has what we call 'positive' control. It enables the secured party to realise the collateral

[57] FCAR reg 4(4). Under Companies Act 1985, s 396 a fixed charge over shares does not require registration in any event, unless it includes a right to the dividends, in which case it may be registrable as a charge over book debts. See CP 164 para 2.63.

[58] The notion of 'control' in the UCC is not the same as the 'control' that must be exercised by a chargee under current law if the charge is to be fixed rather than floating. On the distinction between fixed and floating charges over book debts, see CP para 2.18; *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC); and *Re Spectrum Plus Ltd, National Westminster Bank plc v Spectrum Plus Ltd and others* [2004] EWHC 9 (Ch), [2004] BCLC 335. It will be seen that the definition of control that we now recommend (below, para 5.70) is closely related to the test established by those decisions.

[59] CR draft reg 6(8).

forthwith. This may be contrasted with having only the right to prevent the debtor from disposing of the collateral, which may be called 'negative' control. An example of negative control is when a chargee or other purchaser of a debt notifies the account debtor of the assignment or fixed charge. Provided that the agreement creating the debt does not contain a prohibition on assignment,[60] the account debtor is now bound to pay the assignee/chargee, and will not be discharged if it pays the assignor or follows the assignor's instructions in paying some other party. This has the effect that the debtor is deprived of the power to deal with the debt.

5.47 The CR's draft regulations provided a number of ways in which control could be obtained over investment property and bank accounts. All of them involved the secured party obtaining positive control.

5.48 Among those who responded on the question, there was broad agreement that for bank accounts (and other forms of 'cash', which the draft regulations did not deal with) positive control should not be needed. In other words it should not be necessary, as the CR draft regulations provided, that the secured party either become the account holder or reach an agreement with the bank that it would comply with the secured party's instructions without further consent from the debtor. It should suffice that the secured party had taken negative control by notifying the bank of its assignment or fixed charge.[61]

5.49 For investment property, however, there was general agreement that it was correct to require positive control. It was said that this was important in order to maintain the ready transferability of investment property.

Positive control without negative control

5.50 There was relatively little comment on the second aspect of the test of control on the CR's draft regulations, namely that both for investment property and bank accounts the draft regulations, like the UCC, allowed for what we may call 'positive control *without negative control*.' In other words, provided the bank or intermediary had agreed to comply with the secured party's instructions to transfer the funds or property without reference to the debtor, it did not matter that the debtor remained free to deal with the collateral. However, further work on our part has suggested that this may not be appropriate in the light of the FCD.

'Possession or control' under the Financial Collateral Directive

The requirements of the Directive

5.51 The FCD and the FCAR which implement it confer advantages, for example in insolvency,[62] to financial collateral arrangements, provided that (among other things) the 'financial collateral' is:

[60] On the effect of a prohibition of assignment or charge see below, para 5.66.

[61] It was recognised that a mere notice would not have the necessary effect if the account agreement contained a prohibition of assignment. The bank could then ignore the notice and would still be discharged by paying the debtor. In such a case it would be necessary to obtain the bank's agreement even to get 'negative' control.

[62] See above, para 5.3.

> delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker or a person acting on its behalf.[63]

5.52 'Possession or control' is not defined in the FCD or the FCAR. In the case of indirectly-held investments ('book entry securities collateral'), the matter is governed by 'the law of the country in which the relevant account is maintained' – in other words, by national law.[64] There is no provision for that in the case of directly-held investment property, presumably because it was assumed that the traditional lex situs rule was adequate.[65] Our initial analysis was that it was simply up to national law or the lex situs to define 'control', but we no longer think that is the case. We have to assume that the phrase has an 'autonomous' meaning in European law – in other words, its meaning must depend on interpretation of the Directive and general principles accepted in Community law - and that national law must comply with that meaning. We believe that the terms of the Directive itself, when read in the light of the recitals, show what is meant; and that this is 'negative control'.

5.53 Recital 10 states

> This Directive must… provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding inter alia the risk of fraud. This balance should be achieved through the scope of this Directive covering only those financial collateral arrangements which provide for some form of dispossession, i.e. the provision of the financial collateral…

5.54 'Dispossession' suggests that, for the collateral to be in the 'possession or control' of the collateral taker, at least the collateral provider must be prevented (whether legally or practically) from dealing with the collateral. This is 'negative' control.[66]

5.55 There are several situations in which there is simply no mechanism by which a secured party can 'dispossess' the debtor without at the same time acquiring positive control. The most obvious examples are the arrangements that are possible under the CREST system of settlement for uncertificated directly-held securities. There are three methods by which a secured party can effectively prevent the debtor from dealing with its holding in CREST: by taking the securities into its own name;[67] by having them placed in an escrow account;[68] or,

[63] FCAR reg 3.

[64] FCD art 9; FCAR reg 19.

[65] See Recital 11.

[66] Article 2(2) of the FCD also suggests that the secured party must have negative control. It provides that any right of the collateral-provider to substitute equivalent financial collateral or withdraw excess financial collateral shall not prevent the financial collateral being in the possession or under the control of the collateral-taker. If the Directive contemplated that the debtor might still have power to dispose of the collateral, that provision would be unnecessary for cases in which the debtor had such power, and one would expect there to be some reference to that, but there is none.

[67] This was covered in the CR draft regs by reg 6(5)(a)(i). See now draft reg 40(4)(c) and (d).

[68] See CR draft reg 6(5)(a)(ii). See now draft reg 40(4)(a).

in the case of a CREST settlement bank, by being appointed as the member's 'sponsor'.[69] Each of these not only prevents the debtor from dealing with the securities but also gives the secured party the power to transfer or dispose of the securities without further reference to the debtor.[70] There is no suggestion that in these situations the CREST arrangements are in any way inconsistent with the Directive, which was drafted with CREST in mind. But there is nothing in the FCD to suggest that 'positive control' is necessary in order for the chargee to have 'possession or control' within the meaning of the Directive.[71]

5.56 In cases in which the two forms of control do not necessarily co-exist (leaving aside for the moment any restrictions imposed by the FCD) it would be possible to require either form of control. Take the case of indirectly-held investments.[72] One possibility would be to say that a purchaser would not obtain control merely because it had blocked the debtor from dealing with the collateral by giving notice to the intermediary. The draft regulations in the CR took this approach. They stated that a purchaser (including a secured party) would have control only if it became the entitlement holder or if the intermediary had agreed to transfer the collateral on the purchaser's order without further consent from the entitlement holder. This amounts to a requirement of positive control.[73] An alternative approach would be to require that the chargee obtain negative control by blocking the securities account.

5.57 As consultees pointed out, in practice the secured party will want to obtain positive control if it can, so that it is in a position to realise the collateral without any delay. However, good practice is not necessarily the same as the requirements of the Directive. In the light of our further analysis we now believe that the Directive requires that a secured party who has blocked the debtor from dealing, but who has not obtained 'positive control', is treated as having 'possession and control' for the purposes of the FCAR. The secured party will thus qualify for the advantages conferred by the FCAR.

Control for purposes of perfection distinguished from control for other purposes

5.58 Consultees who argued for a test of positive control said this would preserve and enhance the ready transferability of investment property, and its easy use as

[69] See below, para 5.73.

[70] The same is true of bearer securities: the debtor can only be prevented from dealing with the security by the secured party taking possession, which also gives it the power to dispose of the share.

[71] The provisions on rights of appropriation in art 4 show that 'positive' control is not required. Appropriation is possible only if this has been agreed by the parties in the 'security financial collateral arrangement'. Lack of a power to appropriate and any restrictions on sale in the agreement will not prevent the financial collateral being under the collateral-taker's control. Therefore 'positive' control is not required; it suffices that the collateral-taker cannot deal in the financial collateral.

[72] A similar issue arises in relation to directly-held certificated securities in registered form. CR draft reg 6(3) and (4) had the effect that a purchaser would have control only if it had possession of the share certificates and a signed transfer form. That would give it positive control. It would be able to prevent the debtor from dealing with the shares merely by taking the certficates.

[73] Compare the test that consultees suggested for control over 'cash': above, para 5.48.

collateral. We entirely agree with these general aims. However, we think that ready transferability involves different issues from whether a charge should be registrable, or should have the advantages offered by the FCAR in, for example, insolvency. Ready transferability affects questions of when someone who buys financial collateral that is subject to a security interest should take free of it, and of the priority of competing security interests over the same collateral. We will deal with these issues later.[74]

Should 'possession and control' be defined at all?

5.59 In the light of the analysis we have just made, we were initially inclined to persevere in providing a definition of 'possession or control' for the purposes of the FCAR but to employ a negative control test for both financial instruments and cash. However, there are decisive arguments against attempting to do so. The meaning of the FCD is far from clear. There must be a risk that the European Court of Justice may one day determine that our interpretation was incorrect. If it happened that too narrow an interpretation by us had led to the advantages of the FCD being denied to secured parties who the Court decided were entitled to them, the consequences would be serious.

5.60 We are loath to give up our aim of providing a definition for the purposes of the FCAR. We think it is in general very important that domestic measures implementing European legislation should give the parties clear guidance as to what is required.[75] However, the correct interpretation of the FCD is particularly unclear. We have argued that a party who has not prevented the debtor from dealing with the securities does not have 'possession or control' within the meaning of the Directive, but we reached this conclusion only by interpreting the relevant articles of the Directive in the light of the recitals.

5.61 We have therefore decided that we have to give up our original aim. The question whether collateral is 'in the possession or under the control of' the secured party *for the purposes of the FCAR* should be left to be determined in accordance with the FCD and FCAR. However, we hope that the analysis of the requirements of the FCD and the FCAR in the preceding paragraphs will be useful to those who want to know what is required.

5.62 What we are able to do is to provide a secured party who wishes to know whether or not it needs to register its charge over financial collateral with a 'safe harbour'. The Directive does not require Member States to impose any requirements of registration or form on financial collateral arrangements under which the secured party does not have 'possession or control'. What it does is to prevent Member States from imposing requirements when the secured party does have control. Therefore there is nothing to prevent our scheme from providing that, whatever the meaning of possession or control for the purposes of the FCAR, a party who has control as we define it does not have to file a

[74] See paras 5.95-5.102.

[75] Compare the Law Commissions' recent joint report on *Unfair Terms in Contracts* (Law Com No 292, Scot Law Com No 199, 2005), which has as one of its aims to set out the requirements of the Directive of Unfair Terms in Consumer Contracts in a clearer and more accessible way than in the Unfair Terms in Consumer Contracts Regulations 1999.

financing statement *in order for its charge to be effective in the debtor's insolvency*.

5.63 For this purpose, we think that 'control' should be defined in the 'negative' sense. This is for two reasons. First, this is the sense of control that we believe to be required by the FCD. Secondly, we consider that this is the most appropriate test for questions of perfection, for the reasons set out in the next paragraph.[76]

5.64 The reason for denying effect to a charge that has not been perfected by either filing or control is to make sure that unsecured creditors and other parties (including potential second secured parties) dealing with the company have a chance to discover the charge. We do not see that the existence of the charge will be more readily discoverable because it is the subject of an agreement between the chargee and the intermediary than it will be when the chargee has simply served notice on the intermediary.[77]

5.65 Thus we conclude that for the purpose of deciding whether a charge over financial collateral should have to be registered, the test required by the FCAR is one of negative control only. Positive control as well as negative control is not required and positive control without negative control is not sufficient. Our regulations should take the same approach.

5.66 We would add that in practice whether 'positive plus negative' control or merely negative control is required may make little difference. With uncertificated securities, as we explained earlier, there is no way of obtaining negative control without at the same time obtaining positive control. With indirectly-held securities, the secured party will normally have to obtain the agreement of the intermediary in order to be sure that it has even negative control. This is because a mere notice of assignment or fixed charge will not be effective if the agreement between the intermediary and the account holder contains a prohibition against assignment or charge without the intermediary's consent.[78] In addition, the secured party will want if possible to obtain positive control, so that it is in a position to realise the collateral without delay.

5.67 It is of course possible that a party who has merely taken steps that do not meet the tests set out in the draft regulations may also be held to have satisfied the requirements of the FCD. For example, the European Court of Justice might decide that a secured party who has obtained positive control without negative control is within the FCD.[79] The secured party would then be entitled to the same advantages, including its charge being effective in the debtors' insolvency though

[76] We also think that this is the appropriate test for purposes of priority as between competing secured parties: see below, para 5.94. We think that the question of when a purchaser takes free should be dealt with differently: see below, paras 5.95-5.102.

[77] It is true that it might be slightly easier for an intermediary to overlook a notice of assignment that it has received than an agreement that it had entered, but we do not think the difference will be significant.

[78] There is nothing in the FCD to affect a prohibition of this kind. Indeed Recital 20 states that 'This Directive does not prejudice the operation and effect of contractual terms of financial instruments provided as financial collateral…'. Under art 2(1)(e) 'financial instruments' include indirect holdings of investments securities.

[79] For an example of a situation in which this might be the ECJ's interpretation, see below, paras 5.73 and 5.87 ff.

not registered.[80] Whether a chargee wishes to take the chance that a more liberal interpretation of the FCD is correct is a matter for its legal and commercial judgement.

5.68 **We recommend that a charge over financial collateral should be effective in the insolvency of the debtor although not registered before the onset of insolvency provided that either:**

(1) the collateral has been 'delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker or a person acting on its behalf' within the meaning of the FCAR;[81] or

(2) the secured party has taken control as defined in our regulations, namely, if the debtor is no longer able to deal with the collateral without the agreement of the chargee or pledgee.[82]

A general test of control

5.69 The draft regulations in the CR set out a number of ways in which the secured party could obtain control over the different forms of financial collateral.[83] It was suggested to us that it would be sensible to add a more general test, which could be applied to any new arrangements that might be devised in the future. The various methods of taking control listed should be retained to make it clear how control may be obtained over different types of collateral and under the various arrangements commonly used at present. We agree that this would be a good idea to have both a general test and specific examples. We think the general test should be whether the secured party has negative control, so that the debtor cannot deal with the collateral without the secured party's consent.

5.70 **We recommend that:**

(1) The draft regulations should set out the methods by which control may be taken over different forms of investment property and cash.

(2) There should also be a general provision that the secured party should be regarded as having control over financial collateral for the purposes of our regulations if it has taken steps to ensure that the debtor cannot deal with the collateral without the secured party's consent.[84]

[80] This is because draft reg 36(1) provides that a 'security financial collateral arrangement' (ie a charge under which the chargee has 'possession or control' within the meaning of the FCAR) is effective without registration.

[81] FCAR reg 3.

[82] See draft reg 36.

[83] See CR draft regs 6(1)-(9) and (11)-(13), 7(1)-(5).

[84] See draft reg 40.

The listed methods of taking control

5.71 Draft regulation 40 sets out the ways in which a chargee may obtain control over various types of investment property and over cash. The rules were outlined in the summary at the beginning of this Part.[85] There are some changes from the draft regulation in the CR.[86] First, the listed methods will now apply only to secured parties and not to other purchasers, who will be treated separately. Other changes follow from the switch from positive control to negative control, or in the case of uncertificated securities within CREST, cover an omission. There are three main changes.

(1) CONTROL OVER CERTIFICATED SECURITIES IN REGISTERED FORM

5.72 A secured party will have control over certificated securities in registered form if it is registered as the holder, or if it has obtained possession of the certificates, whether or not it also has obtained a signed transfer form.[87]

(2) CONTROL OVER SECURITIES IN CREST: SPONSORSHIP ARRANGEMENTS

5.73 The methods of taking control over uncertificated securities include, in addition to having the holding transferred into the chargee's own name or into an escrow account, the process by which the secured party can secure its appointment as the sponsor of the debtor.[88] Consultees correctly pointed out that the CR did not deal with this method, which has been developed between CREST and the CREST settlement banks that provide short-term financing to cover any gap between settlement of a deal (payment) and receipt of funds from the buying CREST member. It relies on the rule that a CREST member can surrender its right to give instructions to CREST to a 'sponsor' and, when that has been done, CREST will accept instructions only from the sponsor. (Only certain persons may act as sponsor.) The bank will take a 'system-charge', which will be floating charge over the monies receivable from the member and the member's securities and other entitlements under CREST. The securities remain registered in the member's name and in its 'available balance', so that the member can continue to trade in the securities. However, under the security deed the bank obtains an irrevocable power of attorney to act in the member's name to appoint itself as sponsor. The bank 'pre-lodges' the deed (with the power of attorney) with CREST. The bank does not exercise the power immediately, but if it becomes concerned about the amount owing to it in relation to the securities subject to the charge (each CREST member has a 'debit cap'), the bank can then notify CREST of a 'change of user' (relying on the power of attorney). It will be appointed as sponsor from that moment. Exercise of the power places the securities under effective control of the bank and enables the bank to order that

[85] See above, para 5.20.

[86] CR draft regs 6 and 7.

[87] See above, note 72. CR draft regs 6(3) and (4) required the secured party to have a signed transfer form. See now draft reg 40(3).

[88] It was also pointed out to us that escrow and sponsorship arrangements apply to Irish, Manx, Guernsey, and Jersey securities which are settled through CREST but where it is the entry in the issuer's register that is conclusive as to title. (This was the case with all uncertificated securities until the USR 2001 came into force.) We have made the necessary adjustments to the draft regulations. See draft reg 40(4).

the securities be transferred or sold without delay.[89] This is now covered in the draft regulations as an illustration of how control may be taken over uncertificated securities.[90]

(3) CONTROL OVER INDIRECTLY-HELD FINANCIAL ASSETS AND CASH

5.74 A secured party will have control of financial assets held with an intermediary or over 'cash' in three circumstances: if the assets are transferred to its account; if it has given a notice of its assignment or fixed charge to the intermediary or cash debtor; or, where the latter is entitled to disregard a notice of assignment or charge, the chargee has secured its agreement not to permit the debtor to deal with or dispose of the assets.[91]

CHARGES IN FAVOUR OF AN INTERMEDIARY OR CASH DEBTOR

5.75 If an account holder grants the intermediary a charge over financial assets held in the account with the intermediary, the intermediary should be treated as having control without more. This was provided in the CR and was not criticised. The same rule applies to charges in favour of 'cash debtors'.[92]

'Writing'

5.76 The FCAR, reflecting the FCD,[93] provide that a charge or pledge will amount to a 'security financial collateral arrangement' that falls within the FCAR only if the 'agreement or arrangement' is 'evidenced in writing'.[94] In the CR we included the same requirement of writing as part of the definition of 'control'.[95] Consultees

[89] This form of acquiring 'control' is recognised by the FCAR. Reg 3's definition of a 'security interest' includes: '(d) a charge created as a floating charge where the financial collateral charged is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker'.

[90] See draft reg 40(4)(b).

[91] CR draft regs 6(6)(b) and 7(3)(b) required the intermediary's or cash holders' agreement in all cases. See now draft regs 40(5) and (8). The intermediary my provide a facility which enables the secured party to prevent the debtor from dealing with its entitlement (rather like the CREST escrow account). This is within the wording of draft reg 40(5)(c).

[92] Draft regs 40(6) and (7). In the case of an intermediary, the charge may be for monies advanced to enable the account holder to purchase the financial assets or for other sums owed by the customer. The charge may be fixed but is more likely to be created as a floating charge, so that the account holder may continue to dispose of assets from the account. Thus the intermediary or cash debtor will not have to file. This seems appropriate when the account has been 'blocked' and indeed the FCD probably prevents any requirement of registration in such case. Even where the charge is a floating charge we do not think it is necessary to require that the charge should registered, simply because we think there is no danger that the debtor might appear to enquirers to have unencumbered ownership of the financial assets. The enquirer will need to ask the intermediary or cash debtor whether there are any charges over the account perfected by control and will be told of the intermediary's or cash debtor's own charge. This is the one case in which we think that a floating charge over collateral of any kind need not be registered. The charge will have priority as from the date of creation: see below, para 5.94.

[93] Art 1(5).

[94] FCAR reg 3. This seems to be a lesser requirement than would be imposed by Law of Property Act 1925, section 53(1)(c) (disposition of equitable interest to be in writing and signed), which is disapplied: reg 4(2).

[95] CR draft reg 6(7)(a).

agreed but pointed out that the Statement of Council's Reasons[96] that preceded the FCD makes it clear that the Directive's definition of writing as 'including recording by electronic means and any other durable medium'[97] could include a recording of a telephone conversation. It is said that whereas the FCAR would be interpreted consistently with this, our regulations might not be.[98] The new draft regulations provide expressly that, for the purposes of control over financial collateral, an electronic recording of a conversation will suffice for 'writing'.

5.77 **We recommend that a chargee or pledgee should not have control of financial collateral unless the charge or pledge and the provision of the collateral are evidenced in writing. For the purposes of defining 'control', writing should include an electronic recording of a conversation.**[99]

PRIORITY AND CONTROL

5.78 As we said earlier, one of the main purposes of the provisions on financial collateral is to set out clear rules on the priority of competing security interests over financial collateral. The principal rules are:

(1) As between competing charges over the same financial collateral, a chargee who has obtained control will take priority over a chargee who does not have control, whether or not it had given value and whether or not it knew of the prior interest.

(2) If both chargees have obtained control, priority will (unless agreed otherwise) be in the order that they obtained control.

5.79 The rule that a security interest perfected by control has priority over one perfected by other means (such as filing)[100] is a cardinal principle of Revised Article 9 of the UCC.[101] It reverses the normal approach of the scheme for collateral in general that priority depends on date of perfection.[102] The policy underlying this rule is to enable financial collateral to be taken without the need to search or make enquiries about other possible security interests. In the CR, we included the rule, together with the rule that as between two security interests perfected by control, priority depends on who first obtained control.

5.80 These two rules were supported by consultees. The question that must be asked, however, is whether 'control' for this purpose should be the same as for

[96] Common Position (EC) No 32/2002 adopted 5 March 2002, OJ C 119 E/22 of 22 May 2002.

[97] Art 2(3).

[98] CLLS FLC para 6.41.

[99] See draft reg 40(1).

[100] Under Article 9 it applies also where the security interest is for one reason or another 'temporarily perfected' and where a security interest that has attached is regarded as perfected without more ('automatic perfection'); and where a security interest over an investment security may be perfected by taking delivery of the certificate.

[101] See CR para 4.19.

[102] Subject to the rules giving priority to purchase-money security interests: see CR paras 3.198-3-3.219.

determining whether a charge over financial collateral needs to be registered. Should it be 'positive' control or 'negative' control?

Positive or negative?

5.81 The draft regulations in the CR applied the same test of control for purposes of perfection and to determine the priority of competing security interests over financial collateral. There were three relevant rules:

(1) A charge perfected by control has priority over one perfected by filing.

(2) As between charges perfected by control, priority is by order of control.

(3) A secured party who is a 'protected purchaser' (in other words, a purchaser who gives value and obtains control without knowing that the disposition is in breach of an earlier security agreement) will not be affected by the earlier security interest.[103]

5.82 Priority between competing charges is not affected by the FCD. It is therefore open to us to provide that the priority question should depend on different criteria to those for registration. It would however make matters simpler to use the same criteria.

5.83 We argue below that, for the purposes of the 'protected purchaser' rules, negative control is not the appropriate criterion.[104] For rules (1) and (2), however, we consider that obtaining 'negative' control should be adequate for purposes of priority. In the following paragraphs we explain our reasoning.

5.84 The question needs to be considered from two viewpoints. The first is whether a chargee who has obtained merely negative control, without positive control, should have priority over a chargee who has done no more than register. The second is whether a party who has obtained positive control but who has not obtained negative control should retain priority against a subsequent chargee who gets negative control.

CONTROL TRUMPS MERE FILING

5.85 The first question arises only in relation to situations in which it is possible to have negative control without positive control: in other words, in relation to financial assets held with an intermediary, certificated securities in registered form and 'cash'.[105] It seems to us that negative control should suffice to give priority over a charge that has merely been registered. Suppose SP1 has a floating charge over a securities account. SP2 takes a fixed charge over the same account and notifies the intermediary.[106] The intermediary now knows that it should not allow either the debtor to deal with collateral or SP1 to enforce its

[103] See CR draft reg 32. See further below, para 5.95.

[104] See para 5.99.

[105] See above, para 5.55.

[106] This is not a likely scenario in practice because SP2 will normally wish to obtain positive as well as negative control (see above, para 5.57).

charge without reference to SP2. There is no reason to require SP2 to obtain positive control.[107]

NEGATIVE CONTROL TRUMPS 'POSITIVE WITHOUT NEGATIVE' CONTROL

5.86 In the light of our further analysis and comments from consultees, we have realised that if the 'control trumps filing' rule were to be retained together with a requirement that, to have control, the secured party must have taken steps to prevent the debtor from dealing with the collateral, the effects would be different to either current law or those under the UCC. It may help to give a practical example.

5.87 Take the arrangements between a CREST member, CREST and the settlement banks described earlier.[108] Until the bank has been appointed as sponsor, the debtor is still able to dispose of its holdings in CREST. Therefore the bank will not have control under FCAR and, for the purposes of exemption from registration, it will not have control under our regulations. But should it also be at risk of losing its priority? Or should the (unactivated) 'lodgement' arrangements it has made protect its priority?

5.88 Under current law the settlement bank is at risk of being trumped by a subsequent fixed charge. We understand that the bank will normally try to protect its priority by means of a negative pledge clause. This will protect the bank only if the fixed chargee has knowledge of the clause, but consultees suggest that subsequent potential secured parties will normally make enquiries. They are therefore likely to find the negative pledge clause and to be affected by it. The priority of the bank's floating charge will be preserved.[109]

5.89 If we were to require negative control for purposes of priority as well as for purposes of perfection, the bank would not have control until it exercised its right to 'block' the debtor's securities account. Unless it had done so, its charge would be trumped by the subsequent fixed charge if that were perfected by control. It would lose the chance to protect its priority by means of a negative pledge clause.

5.90 This is not the effect under UCC Article 8 and Revised Article 9. As we explained earlier, under the UCC a bank that has obtained the issuer's agreement to transfer uncertificated securities without further reference to the debtor is regarded as having control, even though the debtor remains free to deal with the collateral.[110] We suspect that on the facts of our example, the bank might be held

[107] Similarly, if the competition is between two chargees each of whom has control, we do not see that the first chargee should have to reach an agreement with the intermediary in order to protect the priority of its charge against a subsequent chargee who perfects by a control agreement. (If the subsequent chargee obtains control without knowledge of the prior charge it will have priority under the purchaser rule described below, para 5.102.)

[108] Above, para 5.73.

[109] It is just because negative pledge clauses are not wholly reliable that we have recommended that, for collateral in general, priority between competing charges should depend on date of filing whether the charges are fixed or floating. See para 3.180 above.

[110] UCC section 8-106.

to have control within the meaning of the UCC. It would not be at risk of its charge being trumped by a subsequent charge.[111]

5.91 Were our scheme to copy the UCC, the same analysis might apply to a CREST settlement bank which has taken a floating charge and has used the pre-lodgement procedures described earlier. Even when it has not yet used its power of attorney to have itself appointed sponsor, it may do so at any moment. It does not have negative control because the debtor is still able to dispose of the 'financial instruments' but it might be held to have control within the relevant provisions of the UCC.

5.92 There is thus a question whether for the purposes of priority (but not for other purposes) we should treat a secured party that has 'positive but not negative' control as having done what is necessary to preserve its priority against a subsequent charge that is perfected by negative control. Similarly, should a secured party that has taken this form of control gain priority over a (floating) charge which is perfected by filing but where the charge-holder has not reached any agreement with the intermediary (or, in the case of a floating charge over securities held in CREST, if the chargee has not pre-lodged documents)?

5.93 Our view is that 'positive but not negative' control should not be a 'priority point'. The reason is that in some cases this would be inconsistent with the general policy, strongly supported by consultees, that lenders should be able to take charges over financial collateral without the need to search. Take the example of the CREST settlement bank. Under current law the existence of the negative pledge clause presents a threat to subsequent lenders. As a consultee pointed out, they will feel they must conduct enquires. If they do not do so, and therefore they do not discover the negative pledge clause, they will in principle not be affected by it, but they might well find that they were embroiled in difficult issues of fact over whether they had actual or constructive notice. Similarly, if under the new scheme the bank were to be treated as having priority because of the pre-lodgement procedures, the subsequent lender would have to search to find out whether a floating charge had been registered and, if so, whether the charge-holder had obtained 'positive control'. We understand that CREST would not reveal this information. To give the bank priority would therefore interfere with the ready use of financial instruments and cash as collateral.

5.94 **We recommend that a security interest over financial collateral of which the secured party has negative control should have priority over one where the secured party does not have negative control, and that priority as between competing charges perfected by control should depend on the date on which negative control was obtained.**[112]

PURCHASERS

5.95 We agree with consultees that it is essential to preserve the ready transferability of financial instruments. A purchaser who acquires a financial instrument for

[111] Unless the subsequent secured party were to be a protected purchaser, which, for reasons we will explain later, is very unlikely. See below, para 5.97, note 114.

[112] See draft reg 39. Other issues of priority over financial collateral are subject to the general rules of priority of the scheme (draft reg 24) or, in the case of priority for further advances, are treated in the same way (draft reg 39(6)).

value and without notice of a security over it should not be affected by a charge or other security over it. That was the aim of the 'protected purchaser' rules included in the draft regulations in the CR. These applies to all purchasers including subsequent secured parties.

5.96 The general aim was strongly supported by consultees. Therefore the draft regulations should provide rules protecting purchasers, including secured parties.

5.97 A remaining question, however, is what steps should the purchaser take if it is to be protected? A person who has merely agreed to buy the entitlement should not be protected.[113] If, in contrast, the financial asset is transferred into the purchaser's name or into a securities account in the purchaser's name, and the conditions as to value and lack of knowledge are satisfied, the purchaser should be fully protected. This is necessary to ensure the ready transferability of the financial instruments.[114]

5.98 Should an 'innocent purchaser' take free only if it has had the collateral transferred into its own name, or into an account in its own name? Or should it suffice that it has obtained 'control' in one or other of its forms? For example, should it suffice that the purchaser has reached a control agreement with the intermediary, not knowing of a charge under which the chargee has also made a control agreement with the intermediary? It appears that under the UCC it suffices that the 'innocent' purchaser has obtained control. [115]

5.99 An outright buyer of the collateral will normally have it transferred into its own name. In practice, therefore, this question will affect only competing secured parties. We have said that a secured party who takes the collateral into its own name – thus, a mortgagee – without knowledge that this is a breach of an earlier charge agreement should be protected. That will ensure that a party wanting to take financial assets and cash as collateral has a safe method of doing so without having to make enquiries. We do not think it is necessary to provide further

[113] Compare the requirement under Sale of Goods Act 1979, s 24. When goods are left in the possession of a seller who sells them to a second, innocent buyer, the goods must have been delivered to the innocent buyer if he is to acquire title. We followed that approach in CR draft reg 31(3).

[114] Needless to say, where the intermediary has been informed of an earlier (fixed) charge, such a transfer should not happen; the intermediary should point out that the collateral is already subject to a charge. If however it does happen, for example through an oversight, the purchaser should take free; the chargee will have a remedy against the intermediary since the latter will not be discharged from its obligation to the chargee.

[115] For directly-held securities, see section 8-303; for indirectly-held securities see section 8-510(a). The CR draft regs, like the proposed Canadian amendments, did not contain an equivalent to the second section: see CR para 4.24.

protection.[116] If the first secured party has allowed the debtor to continue to deal with the collateral, then for reasons explained earlier,[117] the second secured party will in any event gain priority by taking control. If the earlier secured party had obtained control by notifying the intermediary[118] of its assignment or fixed charge, the second chargee who also obtains control by notifying the intermediary will find its charge is subject to the earlier one, but the remedy is in its own hands. It should make enquiries of the intermediary[119] – or demand that the assets are transferred into its own name.

5.100 This solution is, we think, close to the current law. A purchaser who has left the securities in the debtor's own name will have at best an equitable interest. That will be subject to any existing equitable interest. Only if it acquires a legal interest in good faith, for value and without notice of the prior equitable interest will it take free of that interest. However, the innocent purchaser of an indirectly-held security may not qualify as the purchaser of a legal estate, as the interest it is buying may be only equitable. Legal title to the securities lies with the custodian or intermediary registered as the owner.[120]

5.101 We were asked what should happen where a purchaser advances money on the strength of investment property and then learns of a prior charge over it that has been perfected by a control agreement. Should the purchaser gain priority by subsequently becoming the entitlement holder? This was correctly likened to the current doctrine of *tabula in naufragio*, which permits a party who has advanced money without notice of a previous equitable interest, which subsequently he discovers, to secure priority by 'getting in' the legal estate.[121] We think that all the conditions should be fulfilled at the time the purchaser takes control. In relation to the priority of security interests generally the scheme is that priority should be by date of registration, whether the competing interests are legal or equitable, and

[116] Further, we think that adopting the UCC approach would have the effect of changing English law where certificated securities in registered form are concerned. A person who gets the share certificates and a transfer form without knowledge of a previous charge is not entitled to be registered as owner. The issue could only arise in practice if the debtor had managed to obtain duplicate share certificates. If the shares had been mortgaged to SP1, who had taken possession of the first set of certificates, and then sold to B, who merely had possession of the second set plus a signed transfer form, B would not be entitled to be registered as owner. If on the other hand he was registered as owner before the matter came to light we think his interest would override SP1's, which would be purely equitable. So we think the appropriate rule in this case is that the purchaser will take free only if he has been registered as the owner (and has given value and taken without notice, etc.)

[117] Above, para 5.94.

[118] We repeat that this issue will not affect securities within the CREST system. In CREST only one party can have control at any time – the party in whose name the securities are held, or the sponsor, or the party who controls an escrow account in which the securities have been placed. Therefore there is no possibility of a competition with a second party who also has control.

[119] If the intermediary incorrectly replies that it has not been notified of any previous charges, the second chargee will almost certainly have a remedy against the intermediary.

[120] The very difficult topic of the nature of the account-holders interest is discussed in R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) paras 6-10 ff. It is the subject of a Law Commission project: see Ninth Programme of Law Reform (Law Com No 293, 2005), para 1.14.

[121] *Dodds v Hills* (1865) 2 Hem & M 425.

the *tabula in naufragio* doctrine will no longer apply. It would be incongruous for it to apply in relation to the rule for protected purchasers.

5.102 **We recommend that a purchaser for value (including a secured party) who takes financial collateral into its own name without knowledge that the disposition is in breach of a previous charge agreement should take free of the earlier charge.**[122]

AN AUTOMATIC CHARGE IN FAVOUR OF AN INTERMEDIARY

5.103 A broker has a general lien over share certificates until the client pays up.[123] In the CR we asked whether our scheme should follow the UCC in creating a new and more powerful device for intermediaries and others who deliver financial instruments before they have been paid for them when there was no agreement for credit. This gives them a charge over the securities for payment of the price.[124] Such an interest would arise automatically and would not require registration.[125] However the intermediary would not be treated as having control, so that its priority would not be protected against subsequent charges under which the chargee did obtain control.[126]

5.104 Few consultees commented on this question but those who did supported the proposal. We therefore include it in our recommendations, but with the adjustment that where the charge is over financial assets held with an intermediary, the charge should be a fixed charge, as the intermediary will effectively be able to control their disposition. In other cases the charge will be a floating charge, since the buyer will have the certificates and will in effect be able to dispose of the assets.

5.105 **We recommend that:**

(1) An intermediary who credits assets to a buyer's account before being paid for the assets should have a fixed charge over the assets.

(2) A person who delivers certificated financial instruments or assets to a buyer before being paid for them should have a floating charge over the assets.

In neither case will the charge need to be registered; but nor will the chargee be treated as having control.[127]

[122] See draft reg 38.

[123] *Re London & Globe Finance Corpn* [1902] 2 Ch 416; R Goode, *Commercial Law* (3rd ed 2004) p 619.

[124] Section 9-206; see CR 4.84-4.87.

[125] See Section 9-309(9) (a case of so-called 'automatic perfection').

[126] This means that it will be subordinated to the interest of another secured party who takes control, see above, para 5.94.

[127] See draft reg 37.

PROVISIONS THAT HAVE BEEN REMOVED

5.106 Consultees objected to a number of provisions in the CR draft regulations (in addition to those in the statement of rights and remedies in Part 5).[128]

The obligation to disclose a 'control agreement'

5.107 The draft regulations in the CR imposed an obligation on an intermediary or a bank to disclose a 'control agreement' if so requested by the debtor.[129] The core scheme no longer obliges the secured party to give information at the debtor's request; there is no such obligation under current law and there is no evidence that one is needed. We think the same of the obligation on an intermediary or a bank.

Rights of use

5.108 Consultees also objected to the provisions on the right of use of financial collateral. We have concluded that this is not necessary. The right of use was effectively part of the statement of rights and remedies and, like that statement, should be left for consideration at a later date.[130]

'Super-priority' of intermediaries and banks

5.109 The draft regulations in the CR followed the model of the UCC in providing that an intermediary which takes a security interest over a securities entitlement maintained with it should have priority over a security interest in favour of any other party.[131] Similarly, they provided that a charge taken by a bank over an account with itself would have priority over a security interest in favour of any other party unless the other secured party had 'become the account holder'.[132] Consultees thought both to be inappropriate.[133]

5.110 Another respondent commented that such priority should remain subject to arrangements between the various parties.[134] We would like to emphasise that there is no question but that the parties could reach a contractual priority agreement. The only question is what the position should be in default of such an arrangement.

Intermediaries

5.111 In the CR we argued that giving the intermediary priority could be justified when it had provided the finance for the purchase of the investments concerned (that is. the security interest was a purchase-money security interest (PMSI)). However,

[128] On which see para 5.15 above.

[129] CR draft regs 6(10) and 7(7).

[130] See above, para 1.70.

[131] CR draft reg 34 r 4.

[132] CR draft reg 35 r 3.

[133] CLLS FLC paras 6.69 and 6.71.

[134] Lloyds TSB plc.

we questioned whether a wider priority, as provided in the draft regulations, was justified – for example by the convenience of borrowing from the intermediary.[135]

5.112 We consider that there is no particular reason to give the intermediary priority in respect of anything that is not a PMSI. The respondent that criticised this rule also argued, however, that it was quite correct that the PMSI rule[136] should not apply to investment securities. This is more difficult, but after some reflection and helpful discussion with other consultees we have concluded that PMSI rules are unnecessary for investment securities.

5.113 The intermediary can protect its interests by taking a charge over the securities account as soon as it is opened. It will have control without more,[137] and thus will have priority over any subsequent chargee.[138]

Bank accounts

5.114 Similar comments were made about the rule giving super-priority to a bank that takes a charge over an account held with itself. Similar arguments have led us to conclude that the bank (or any other cash debtor) can in practice protect the priority of its own charge over the account without the need for a special priority rule.[139]

[135] See CR paras 4.55 and 4.74, esp n 105.

[136] See CR para 3.204.

[137] Compare the automatic charge which arises under draft reg 37. In the case of the automatic charge the intermediary does not have control within the meaning of the regulations and therefore its priority is not protected.

[138] Other than one who is a protected purchaser under the rules discussed earlier. See above, para 5.102.

[139] The bank can insert in the account agreement a prohibition of assignment or charge without its consent, so that a third party chargee will need the bank's agreement in order to obtain control. In any event, under English law the bank's right of set-off is so extensive that in practice a charge in favour of the bank probably achieves little extra. We have removed from the draft regs a provision about a bank's rights of set-off (CR draft reg 35(2)), which seemed to give rise to concern. We think the provision is unnecessary.

PART 6
LIST OF RECOMMENDATIONS

We make the following recommendations:

6.1 There should be a new scheme of registration of company charges, to replace Part XII of the Companies Act 1985, and for the priority of security over company property. The scheme should apply also to sales of receivables by a company.

THE CORE SCHEME

Scope

6.2 The scheme should apply to security created by companies registered in England and Wales and by Limited Liability Partnerships. (Paragraph 3.12)

6.3 Any charge created by a company should be registrable unless specifically exempted. (Paragraph 3.16)

6.4 A pledge under which the debtor has possession of collateral and attorns to the pledgee should have to be registered as if it were a charge. (Paragraph 3.21)

6.5 If negotiable instruments or documents of title have been pledged, or goods are held by a third party bailee to the order of a pledgee, and the collateral is released into the possession of the debtor for limited purposes such as sale, the pledge (and the pledgee's interest in the proceeds) should be treated as a charge over the goods and their proceeds. The charge must be registered within 15 days unless the collateral is returned to the creditor's possession before that time. A buyer who does not know of the pledge will take free of it. (Paragraph 3.25)

6.6 Liens that arise by operation of law should be subject to the scheme only for the purposes of priority. (Paragraph 3.27)

6.7 For the purpose of the scheme, pledges should include contractual liens. (Paragraph 3.29)

6.8 In relation to land:

(1) Fixed charges over registered land should not have to be registered on the Company Security Register if they are registered or made the subject of a notice on the Land Register.

(2) Information about charges registered at the Land Registry should be forwarded to Company Security Register and made available with other information about company charges.

(3) Charges over unregistered land, and any floating charge affecting land, should be registrable on the Company Security Register whether or not they are registered on the Land Charges Register. (Paragraph 3.38)

6.9 Charges over registered ships and aircraft, and over the forms of intellectual property for which there is a specialist mortgage register, should be registrable on the Company Security Register whether or not the charge is registered on the specialist register. (Paragraph 3.41)

6.10 We recommend that Lloyd's trust deeds other than a Lloyd's Deposit Trust Deed or a Lloyd's Security and Trust Deed should be exempt from the scheme. (Paragraph 3.45)

6.11 Special provisions should apply where a charge is taken over a receivable, a document of title, a negotiable instrument or investment property and the charge covers a right to the proceeds of a letter of credit or a guarantee or indemnity which supports the principal obligation. If the charge over the principal obligation has been registered, the charge over the 'supporting obligation' should not have to be registered. (Paragraph 3.48)

6.12 Where a charge is duly registered in respect of the original collateral, any right to the proceeds of the collateral arising other than only as a result of the terms of a floating charge should also be treated as registered. (Paragraph 3.58)

6.13 Where a company acquires property from another company subject to a registered charge, or acquires property from an individual or unincorporated business subject to a valid charge, the charge should be effective in the insolvency of the acquiring company although no financing statement has been filed against that company. (Paragraph 3.63)

6.14 There should be no need to file a fresh financing statement when a company changes its name. (Paragraph 3.66)

6.15 It should be possible to alter the financing statement to record the transfer of a charge from one party to another, but this should not be required in order to preserve the effectiveness of the charge. (Paragraph 3.68)

The requirement to register

6.16 There should be a Company Security Register in electronic form and the Registrar should make rules requiring information for registration to be submitted in an electronic form. (Paragraph 3.71)

6.17 The duty on the company to send particulars of charges for registration should be removed. (Paragraph 3.73)

6.18 The charge document should no longer be presented for registration, and the Registrar should no longer check the accuracy of the particulars or issue a conclusive certificate of registration. (Paragraph 3.76)

6.19 It should not be compulsory to register a charge but an unregistered charge should be:

(1) at risk of losing priority to one that is registered first; and

(2) ineffective against a liquidator or administrator on insolvency, and against execution creditors. (Paragraph 3.78)

6.20 The time-limit for registration should be removed. (Paragraph 3.82)

6.21 Section 245 of the Insolvency Act 1986 should be amended to apply to any floating charge in favour of the persons mentioned in that section that is created or filed within the times stated before the onset of insolvency, save when new value is given or the company is not insolvent at the time, as provided in section 245(3) and (4). (Paragraph 3.85)

6.22 It should be possible to file a financing statement before any security agreement has been made. However:

(1) The filing party should be required to state that the filing relates to an existing security agreement or the debtor has consented to filing in advance.

(2) Parties who file when there is no security agreement and the debtor has not consented to the filing should be liable to the debtor for any loss caused, unless they had a reasonable excuse.

(3) There should be a penalty for making the statement knowing that it is false. (Paragraph 3.91)

Details of filing and searching

6.23 The financing statement should contain:

(1) the name of the debtor and its registered number (if any);

(2) the name and address of the chargee or its agent;

(3) a description of the collateral;

(4) whether the filing is to continue indefinitely or for a specified period; and

(5) such other matters as may be prescribed by the Rules. (Paragraph 3.98)

6.24 A filing against a company registered in Great Britain, or that has a registered place of business or branch here, should not be accepted unless both the name and company number are given and they match. (Paragraph 3.103)

6.25 It should be possible for the chargee to file in its own name or through an agent, so that only the name of the agent will appear on the financing statement. (Paragraph 3.106)

6.26 There should be no word limit on the description of collateral in the financing statement. (Paragraph 3.109)

6.27 A filing (unless discharged) should be effective either indefinitely or until such date as is indicated on the financing statement. (Paragraph 3.111)

6.28 Charges over property held by the debtor company in trust should be registrable in the same way as charges over property held beneficially. (Paragraph 3.115)

6.29 The financing statement should permit the party filing to record that the chargee is a trustee for others. (Paragraph 3.117)

6.30 The Registrar should have power to make Rules that may require further information on the financing statement. (Paragraph 3.120)

6.31 When a financing statement has been filed:

(1) The Registrar should have to send a verification statement to the party who has filed, unless that party has waived the right to receive a verification statement.

(2) Where the debtor is a company that is registered in Great Britain or has registered a place of business or branch in Great Britain, the Registrar should be obliged to send a copy of the verification statement by post to its registered address (or by e-mail to any e-mail address registered for the company), unless the debtor has waived the right to receive a copy.

(3) Where the debtor is a company that is not registered in Great Britain and has not registered a place of business or branch in Great Britain, the Registrar should be obliged to send a verification statement to the party who has filed, and the latter should be obliged to send a copy of the statement to the debtor within 10 business days, unless the debtor has waived the right to receive a copy. A chargee who fails to do this without reasonable excuse should be liable in damages to the company named as debtor. (Paragraph 3.123)

6.32 In relation to errors on the financing statement:

(1) The effectiveness of a filing should not be prejudiced by a defect, irregularity, omission or error in the financing statement unless it would have the result that a search that is conducted in a reasonable manner, in accordance with the requirements of the draft regulations and the Rules relating to searches, would not reveal the financing statement;

(2) An error in the collateral description should result in the charge being ineffective in the debtor's insolvency, and at risk of loss of priority, in relation to collateral that was omitted. However, it should be effective against other collateral described in the financing statement. (Paragraph 3.131)

6.33 The following rules on the correction or removal of a financing statement should be adopted:

(1) The chargee should be able to amend the financing statement by filing an 'additional statement'.

(2) The debtor (or any other person with an interest in the property) should be able to obtain the correction or removal of a financing statement by giving a notice in writing (a 'requirement' notice) to the party named as chargee (or its agent). This would require the chargee to file a financing change statement within 15 days or commence court proceedings.

(3) If no court order has been obtained at the end of 90 days or such longer period as the court may direct, the debtor should be able amend or remove the filing itself.

(4) If the financing statement indicates that the chargee is a trustee, the person named as debtor should have to obtain a court order to have the financing statement amended or discharged. (Paragraph 3.137)

6.34 In relation to the effect of an unauthorised or accidental discharge:

(1) Where there has been a mistaken or unauthorised discharge of a financing statement, the chargee should be able to re-activate the financing statement within 30 days of discharge. Where this is done, the discharge should not affect the priority ranking of the charge as against charges or pledges which, prior to the discharge, were subordinate in priority to it.

(2) However, this should not apply to the extent that the competing charge secures advances made or contracted for in the period between discharge and re-activation. The Rules should deal with the procedure for re-activation of the financing statement. (Paragraph 1.139)

6.35 It should be possible to search the register on-line by the company name, the company registered number, if any, or the financing statement number (the number allocated by the registry on filing). (Paragraph 3.141)

Priority

6.36 There should be the following 'residual' priority rules for fixed charges:

(1) Registered charges should take priority over unregistered ones;

(2) As between secured parties with registered charges, priority should be determined by whoever was first to file its financing statement;

(3) As between unregistered charges, priority should determined by date of creation;

(4) The priority that a charge has under the rules above should apply to all advances, including future ones (whether or not made under an obligation). (Paragraph 3.155)

6.37 Priority between a charge and a pledge should be determined by whether the financing statement relating to the charge is registered before the pledge is created. (Paragraph 3.157)

6.38 The distinction between fixed and floating charges should be retained for the time being. The issue should be revisited when insolvency law is next reviewed. (Paragraph 3.175)

6.39 The priority of a charge against another charge or a pledge should depend on the date of registration of the financing statement whether the charge is fixed or floating. (Paragraph 3.180)

6.40 The Insolvency Act 1986 should be amended to provide that:

(1) As against the preferential creditors and the unsecured creditors' fund, a floating charge should have priority to the extent of any fixed charges over which it has priority.

(2) A subordination agreement by which the floating charge holder agrees that a subsequent fixed charge will have priority, or any other arrangement that a fixed charge will have priority to a floating charge, should result in the fixed charge also having priority over the preferential creditors and the unsecured creditors' fund. (Paragraph 3.187)

6.41 A lien that arises by operation of law should take priority over a charge, whether registered or unregistered. (Paragraph 3.189)

6.42 A charge over a supporting obligation that is not separately registered should have the same priority as the principal obligation; but when the charge is over the sums due under a letter of credit, a chargee who notifies the bank of its charge should have priority over one who has merely registered. (Paragraph 3.194)

6.43 Where a chargee transfers its rights, the transferee should acquire the same priority with respect to the charge as the transferor had at the time of transfer. (Paragraph 3.196)

6.44 If collateral is transferred by the debtor to a party who takes subject to the charge, then provided the chargee's interest was (if necessary) registered at the time of transfer and has remained so, it should have priority over any charge created by the transferee. This should be so whether the charge created by the transferee was created or filed before or after the charge created by the transferor. (Paragraph 3.200)

6.45 As regards execution creditors:

(1) An execution creditor should have priority over a charge that is unregistered at the time the execution creditor's interest arises.

(2) An execution creditor's interest should be subject to a charge that was registered at the relevant time, whether the charge was fixed or floating.

(3) However, a chargee or pledgee should not have priority in respect of further advances made after it knows that the execution creditor has acquired an interest in the goods, unless at that time the chargee was under an obligation to make the advance. (Paragraph 3.204)

6.46 A landlord's right to distrain on goods for unpaid rent should take priority over any mortgage or charge over them, whether registered or not. (Paragraph 3.207)

6.47 A registered charge, whether fixed or floating, should have priority over the right of a local authority to distrain for rates. (Paragraph 3.209)

6.48 In relation to transferees (other than secured parties):

(1) Transferees for value of collateral that is subject to an unregistered fixed charge should take free of the charge unless they know of it.

(2) Transferees of collateral subject to a unregistered floating charge, who acquire the collateral in a transaction which was in the ordinary course of the transferor's business, should take free of the charge unless they know that the transfer is in breach of the terms of the floating charge. (Paragraph 3.216)

6.49 A transferee (other than a secured party) of collateral that is subject to a registered charge which is a fixed charge should take subject to the charge unless the chargee has authorised the sale or other disposition. (Paragraph 3.218)

6.50 A transferee (other than a secured party) of collateral subject to a registered charge which is a floating charge, who acquired the collateral in a transaction which was in the ordinary course of the transferor's business, should take free of the charge unless the transferee knew that the sale was in breach of the terms of the charge. (Paragraph 3.221)

6.51 The rules of the scheme should be without prejudice to the rights of transferees of negotiable instruments, negotiable documents of title and money, whether transferred in cash or by cheque or electronic transfer. (Paragraph 3.224)

6.52 The scheme should have no special provisions for the registration or priority of charges over fixtures. (Paragraph 3.226)

6.53 A registered charge over growing crops (whether planted or natural) should have priority over a conflicting interest in the land, if the debtor has an interest in or is in occupation of the land. (Paragraph 3.228)

6.54 The definition of crops should exclude timber, so that timber that has not yet been cut will not fall within the definition of either crops or goods. (Paragraph 3.230)

6.55 Where the legislation that establishes a specialist registry contains rules determining the priority of competing charges, those should apply in place of the general rule of priority from date of filing. (Paragraph 3.235)

6.56 In relation to land:

(1) The priority of fixed charges over unregistered land should not be affected by the date of registration in the Company Security Register.

(2) The priority of a floating charge over a company's unregistered land as against competing charges over the same land should depend on their respective dates of registration. If the financing statement covering the floating charge was registered before the date of registration of the financing statement covering the competing charge (or, where relevant, the date of registration of the charge in the Land Charges Register) then the floating charge should take priority. If it was registered after that date, then the competing charge should take priority.

(3) Subject to the provisions of the Land Registration Act 2002, the priority of fixed charges over registered land should depend on the order of registration, whether that be registration of a financing statement on the Company Security Register or registration or notice at the Land Registry.

(4) The priority of a floating charge over a company's registered land as against competing equitable charges over the same land should depend on their respective dates of registration. If the financing statement covering the floating charge was registered before the date of registration of the financing statement covering the competing charge (or, where relevant, the date of registration of the charge in the Land Register) then the floating charge should take priority. If it was registered after that date, then the competing charge should take priority. (Paragraph 3.245)

Territorial application

6.57 The regulations should apply to charges created by a company registered in England and Wales over its assets wherever they are located but without prejudice to the rights acquired by the chargee or third parties in assets according to the law of the jurisdiction where the assets are situated. (Paragraph 3.258)

6.58 The full scheme should apply to charges created by any oversea company over assets in England and Wales. (Paragraph 3.268)

6.59 Existing charges over goods brought into the country by an oversea company should have to be registered within 60 days of the import. (Paragraph 3.270)

6.60 For the purposes of the scheme, registered aircraft and registered ships belonging to oversea companies should be treated as 'situated' in the country where they are registered, regardless of their actual location at the relevant time. (Paragraph 3.272)

6.61 A charge created by an English company over assets in Scotland should be subject to the scheme, including the normal rules of registration. (Paragraph 3.280)

6.62 In relation to charges created by Scottish companies over assets in England and Wales:

(1) If the scheme of registration of charges created by companies registered in Scotland remains unchanged, registration at Companies House in Edinburgh should be treated, in relation to the company's assets in England, as due registration for the purposes of English law; the remainder of the scheme should apply to charges created by a Scots company as it does to an oversea company.

(2) If the recommendations of the Scottish Law Commission are implemented, charges created by a company registered in Scotland over assets in England and Wales should be treated in the same way as charges created by an oversea company. (Paragraph 3.284)

Transitional provisions

6.63 Pre-commencement registrable charges that were registered before commencement should be treated as registered under the scheme. They should retain their existing priority as against other pre-commencement charges and pledges. As against post-commencement security interests, their priority should depend on the normal rules of priority of the new scheme. (Paragraph 3.287)

6.64 Charges which before commencement of the scheme were not registrable should not have to be registered after the scheme comes into effect. They should retain their existing priority as against other pre-commencement charges and pledges, and (whether fixed or floating) should have priority over post-commencement interests. (Paragraph 3.290)

Provisions of Companies Act 1985 Part XII

6.65 The new scheme should provide for the registration of the appointment of a receiver or manager. (Paragraph 3.294)

6.66 From the point of view of the law of security, there is no reason to require the company to keep its own register. (Paragraph 3.300)

Should charges be evidenced in writing signed by the debtor?

6.67 For charges over collateral (other than financial collateral) there should be no requirement that the charge agreement be in writing. (Paragraph 3.306)

SALES OF RECEIVABLES

Registration and priority of sales of receivables

6.68 Priority of sales of receivables by companies should depend on the date of registration of the financing statement relating to the sale in the Company Security Register. (Paragraph 4.18)

6.69 The sale of a receivable by a company should not be effective against an administrator or liquidator of the company unless it has been registered by the onset of insolvency. (Paragraph 4.25)

6.70 The definition of a receivable for the purpose of our scheme should include only a monetary obligation, whether or not it has been earned by performance, arising from goods or services supplied, energy services supplied or brokerage fees. (Paragraph 4.29)

6.71 The following should be exempt from the scheme:

(1) the assignment of an unearned right to payment under a contract to a person who is to perform the transferor's obligations;

(2) the assignment of receivables solely to facilitate collection on behalf of the person making the assignment;

(3) the assignment of a single receivable to an assignee in full or partial satisfaction of a pre-existing indebtedness; and

(4) the sale of receivables as part of the sale of a business out of which the receivables arose (Paragraph 4.31)

6.72 A sale of receivables should not need to be registered if the sale (by itself or in conjunction with other sales to the buyer) is of such a small proportion of the assignor's receivables that it would not influence a reasonable person deciding whether to make an advance to the company. For priority purposes, it should be treated as if it had been registered on the date of the sale. (Paragraph 4.34)

Prohibitions against assignments of receivables

6.73 In a contract between a company and a third party creating a receivable payable to the company, a term that purports to prohibit or restrict assignment of the account should be of no effect against a third-party assignee. (Paragraph 4.40)

Territorial application

6.74 The provisions on sales of receivables should apply only to sales by companies registered in England and Wales. (Paragraph 4.45)

Transitional arrangements

6.75 Existing agreements to sell receivables should have to be registered within two years of the commencement of the scheme. During the transitional period, an interest arising under an existing agreement should have priority over any conflicting charge or sale entered into after commencement (whether registered or not). An existing sale registered within the transitional period should be treated as if it had been registered at the date of commencement. (Paragraph 4.48)

FINANCIAL COLLATERAL

Scope of the provisions on financial collateral

6.76 The regulations should refer to 'financial instruments', reflecting the definition of 'financial instruments' in the Financial Collateral Arrangements (No 2) Regulations 2003 ('FCAR') with the qualifications that:

(1) the definition should apply only to directly-held financial instruments, since indirect holdings are treated differently and are covered by other definitions, and

(2) the definition should include CREST Depository Instruments and similar assets that are constituted as uncertificated securities. (Paragraph 5.27)

6.77 Rights under commodity contracts and to commodities held with an intermediary should be treated in the same way as other financial collateral. (Paragraph 5.32)

6.78 The rules on control over financial collateral should apply to bank accounts and all other forms of 'cash' within the meaning of the FCAR. (Paragraph 5.35)

6.79 The regulations should use terminology that reflects that of the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary and the FCAR. They should refer to 'financial assets held with an intermediary' and 'account holder' and should define 'securities account' and 'intermediary' in ways that fit with the Convention and the FCAR. (Paragraph 5.41)

6.80 A charge over financial collateral should be effective in the insolvency of the debtor although not registered before the onset of insolvency provided that either

(1) the collateral has been 'delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker or a person acting on its behalf' within the meaning of the FCAR; or

(2) the secured party has taken control as defined in the regulations, namely, if the debtor is no longer able to deal with the collateral without the agreement of the chargee or pledgee. (Paragraph 5.68)

6.81 In relation to the test of control:

(1) The draft regulations should set out the methods by which control may be taken over different forms of investment property and cash.

(2) There should also be a general provision that the secured party should be regarded as having control over financial collateral for the purposes of the regulations if it has taken steps to ensure that the debtor cannot deal with the collateral without the secured party's consent. (Paragraph 5.70)

6.82 A chargee or pledgee should not have control of financial collateral unless the charge or pledge and the provision of the collateral are evidenced in writing. For the purposes of defining 'control', writing should include an electronic recording of a conversation. (Paragraph 5.77)

6.83 A security interest over financial collateral of which the secured party has negative control should have priority over one where the secured party does not have negative control, and priority as between competing charges perfected by control should depend on the date on which negative control was obtained. (Paragraph 5.94)

Purchasers

6.84 A purchaser for value (including a secured party) who takes financial collateral into its own name without knowledge that the disposition is in breach of a previous charge agreement should take free of the earlier charge. (Paragraph 5.102)

An automatic charge in favour of an intermediary

6.85 Charges should arise automatically as follows:

(1) An intermediary who credits assets to a buyer's account before being paid for the assets should have a fixed charge over the assets.

(2) A person who delivers certificated financial instruments or assets to a buyer before being paid for them should have a floating charge over the assets.

In neither case will the charge need to be registered; but nor will the chargee be treated as having control. (Paragraph 5.105)

(Signed) ROGER TOULSON, *Chairman, Law Commission*
HUGH BEALE
STUART BRIDGE
JEREMY HORDER
MARTIN PARTINGTON

STEVE HUMPHREYS, *Chief Executive*
7 July 2005

APPENDIX A
DRAFT COMPANY SECURITY REGULATIONS AND EXPLANATORY NOTES

INTRODUCTION

The draft Company Security Regulations 2006, set out from page 160 onwards, would be made under powers to be taken in the Company Law Reform Bill. They provide a scheme for electronic registration of company charges and associated rules of priority. The regulations would replace Part XII of the Companies Act 1985.

There is wide agreement that the current system for registration is out of date and needlessly expensive to operate. For example, documentation must be submitted to the Registrar of Companies in paper form. It must be checked by Registry staff before a Certificate of Registration is issued. A certificate must be obtained before a mortgage over land can be registered, which is hindering the development of electronic conveyancing. Charges must be registered within a 21-day period, which results in substantial costs when, as regularly happens, charges are not registered on time. The list of registrable charges is out of date and the requirements for charges created by oversea companies over their assets in England and Wales are defective.

The registration scheme was not designed to solve issues of priority between creditors and buyers or between different creditors with an interest in the same security. However, the current system has a major impact on priority rules. This is because a charge that is not registered within 21 days is void against other creditors and because registration of a charge has been held to give constructive notice to others. The rules on priority are both unclear in their operation and unsuited to the needs of modern company finance.

The regulations permit the introduction of a wholly electronic system under which a lender taking a charge over a company's property will 'file' brief particulars of the charge on-line to the registry. Parties will no longer submit charge documents and the Registrar will no longer have to employ staff to check the particulars. The party filing will be responsible for ensuring that the information about the charge is accurate. The on-line system will be designed to minimise the chances of error and, if property is accidentally omitted, the charge will still be effective in respect of the property that was included in the particulars.

Registration will take place, and information will be available for on-line searching, almost instantaneously. The system will provide fuller information than the current register, as any charge will be registrable unless specifically exempted. This will include all non-exempt charges created by oversea companies over their assets in England and Wales. Charges over registered land that are registered at the Land Registry will no longer have to be registered at Companies House as well; the relevant information will be sent automatically to the Company Security Register so that it is available to searchers.

Registration will no longer be compulsory and there will be no time limit. But if the company becomes insolvent before a charge has been registered, the charge will be ineffective as against the administrator or liquidator. It may also be invalidated if the filing was made shortly before the insolvency. Until it has been registered, a charge may lose its priority to a subsequent charge, as priority will depend primarily on the date of filing. An unregistered charge will not be effective against a person who buys the property unless they know of the charge.

The effectiveness of floating charges will be enhanced. Their essential characteristic, that the company remains free to dispose of its assets in the ordinary course of business, is preserved. However it will no longer be necessary to employ negative pledge clauses to preserve the priority of a floating charge against subsequent charges. Nor will it be necessary to use automatic crystallisation clauses to prevent seizure of the property by other creditors. Both types of clause are unreliable in their operation and add significantly to the complexity of the current law.

There are special provisions for charges over 'financial collateral' such as investment property and funds in bank accounts. The provisions complement the Financial Collateral Arrangements (No 2) Regulations 2003 and other legislation affecting financial collateral. They set out clear rules as to the priority of charges where the chargee takes 'possession or control' of the financial collateral instead of registering, and on when a person who purchases financial collateral without knowing of the charge will be affected by it. These provisions are essential to maintain the ready transferability of financial collateral.

For many companies, receivables are a major asset and sales of their receivables, for example to a factor or discounter, are a more important way of raising finance than creating charges. It is difficult for financiers and others to discover whether companies have sold their receivables. The rules of priority, which depend on the order in which notice is given to the debtor from whom the receivable is due, are unsuited to modern receivables financing. The regulations provide for registration of sales of receivables. Their priority will depend on the order in which they are registered. The regulations also provide that a term in the contract that gives rise to the receivable purporting to prohibit its assignment will be of no effect against the assignee. This removes a serious but often unintended obstacle to many small companies obtaining receivables financing.

The regulations have been drafted on the assumption that the recommendations of the Scottish Law Commission in its Report on Registration of Rights in Security by Companies (Scot Law Com No 197, 2004) will be implemented.

The regulations normally define a term on the first occasion on which it is used. Regulation 43 provides an index showing where the definition of any defined term will be found.

STATUTORY INSTRUMENTS

2006 No. xxxx

COMPANIES

The Company Security Regulations 2006

Made - - - -

Laid before Parliament

Coming into force - -

ARRANGEMENT OF REGULATIONS

The Secretary of State in exercise of the powers conferred on him by sections [x, y and z of the Companies Act 2006] hereby makes the following Regulations:

PART 1

INTRODUCTION

Citation and commencement

Citation and commencement

1.—(1) These Regulations may be cited as the Company Security Regulations 2006.

(2) These Regulations come into force on [date].

Scope of the Regulations

Companies registered in England and Wales

2.—(1) These Regulations apply to—

(a) any charge or pledge created by a company registered in England and Wales over any of its property (wherever situated), and

(b) any sale of receivables by a company registered in England and Wales.

(2) If the property is situated in a jurisdiction outside England and Wales, these Regulations do not affect any right acquired in, or in relation to, the property in accordance with the law of that jurisdiction.

(3) In these Regulations—

"charge" includes a mortgage,

"receivables" means monetary obligations, whether or not earned by performance, arising from—

(a) the supply of goods or services (other than insurance services),

(b) the supply of energy, or

(c) brokerage fees, and

"sale", in relation to receivables, includes an agreement to sell.

EXPLANATORY NOTES

PART 1 INTRODUCTION

Citation and Commencement

Regulation 1 Citation and Commencement

The title 'Company Security Regulations' reflects the fact that the Regulations apply not only to charges but also to pledges (dealing with their priority as against charges) and to sales of receivables.

Scope of the Regulations

Regulations 2-4 deal with the scope of the Regulations.

Regulation 2 Companies registered in England and Wales

The scheme applies to charges over the assets of a company registered in England and Wales, and to sales of its receivables.

It is immaterial whether a charge that is created by a company secures its own obligation or those of a third person (regulation 6(5) 'debtor'). It is equally immaterial whether or not the chargee is a company. For the purposes of the Regulations, a person who holds security as trustee for a number of others is treated as the chargee (regulation 6(5) 'chargee').

The Regulations apply wherever the asset is situated (whether physically or, with intangible assets, according to the rules of private international law). In this the Regulations follow the Companies Act 1985, section 395. However regulation 2(2) reflects the position in practice that interests recognised by the law of the place where the asset is 'situated' will be frequently be given effect by that law regardless of whether the charge should have been registered in England and Wales. (Under current law this is required when article 5 of the Insolvency Regulation[1] applies.) Note that the Regulations are subject to various exceptions set out in regulation 4.

This regulation includes the definition of 'receivables', since the sales of receivables by companies registered in England and Wales will need to be registered to be effective (regulation 20). Priority will depend on date of registration (regulation 24.) The definition is a deliberately narrow one. The requirement to register sales of receivables applies only to the kinds of monetary obligations that are commonly sold by companies to factors or discounters. It does not apply, for example, to rent or payments under mortgages or credit card loans. However, a charge over any form of receivable is within the scheme.

[1] Regulation on Insolvency Proceedings, Council Regulation (EC) No 1346/2000 of 29 May 2000, OJ L160/1, June 30, 2000.

Other companies

3.—(1) These Regulations also apply to any charge or pledge created by a company registered in Scotland, or by a company registered elsewhere than in Great Britain (a "foreign company"), over its property situated in England and Wales.

(2) For the purposes of paragraph (1)—

(a) an aircraft is treated as situated in England and Wales while it is registered in the UK Aircraft Register of Civil Aircraft maintained under the Air Navigation Order 2000(**a**), even if it is not in England and Wales at the time in question, and

(b) a ship is treated as situated in England and Wales while it is registered in Part 1, 2 or 3 of the register of British ships maintained under section 8(1) of the Merchant Shipping Act 1995(**b**), even if it is not in England and Wales at the time in question;

but an aircraft or ship which is registered only under the law of any other jurisdiction does not fall within paragraph (1), even if it is in England and Wales at the time in question.

Exceptions

4.—(1) These Regulations do not apply to—

(a) a lien, charge or other interest arising under an enactment or rule of law,

(b) the assignment of an unearned right to payment under a contract to a person who is to perform the transferor's obligations,

(c) the assignment of receivables solely to facilitate collection on behalf of the person making the assignment,

(d) the assignment of a single receivable to an assignee in full or partial satisfaction of a pre-existing indebtedness,

(e) the sale of receivables as part of the sale of a business out of which the receivables arose,

(f) a fixed charge which is registered, or the subject of a notice, under the Land Registration Act 2002(**c**), or

(g) a charge arising from the creation of a Lloyd's relevant trust fund, other than a Lloyd's deposit.

(2) Paragraph (1) is subject to these Regulations and in particular to regulations 25 and 31 (which affect the priority of certain charges over land and liens).

(**a**) S.I. 2000/1562.
(**b**) 1995 c. 21.
(**c**) 2002 c. 9.

EXPLANATORY NOTES

Regulation 3 Other companies

Charges created by a company registered outside Great Britain over assets in England and Wales will come within the scheme whether or not the company has a branch or a place of business in England and Wales. Such charges will need to be registered in order to be effective in insolvency (unless exempted from registration). Similarly, their priority as against other security and as against a person who buys the property subject to the charge will be governed by the scheme. There will be special provisions for goods that are subject to a charge when they are brought into England and Wales (regulation 21). However, to reduce the uncertainty over aircraft and ships that are likely to move in and out of the country frequently, special rules apply to registered aircraft and registered ships. They will be regarded as situated in England and Wales if they are registered in the UK, and as not situated here if they are registered abroad, regardless of their physical location.

Implementation of the Scottish Law Commission Report on Registration of Rights in Security by Companies (Scot Law Com No 197, 2004) will mean that, under Scots law, the text of floating charge deeds must be registered in a Register of Floating Charges. Charges created by Scottish companies will not be registered with the Registrar of Companies. Under regulation 3, to enable those dealing with the company's assets in England and Wales to discover whether the assets are subject to a charge, the charge will be registrable in the same way as a charge created by a company registered outside Great Britain.

The provisions on sales of receivables do not apply to a company registered outside England and Wales, whether or not the company has registered a branch or place of business in Great Britain.

Regulation 4 Exceptions

With the introduction of electronic conveyancing, it will become unnecessary for registered charges over registered land to be registered also at Companies House. The Land Registry already has the power to forward information about such charges to Companies House. Under the scheme, information will be forwarded routinely and made be available to those searching the Company Security Register. The scheme applies to such charges only to the extent that it deals with competing priorities between these and other charges over the land (regulation 25).

Liens and charges created by operation of law (regulation 4(1)(a)) are also outside the scheme, save that their priority as against other charges is dealt with by regulation 31.

The scheme contains a special exemption for Lloyd's Trust Deeds (see regulation 4(1)(g)). When a corporate member joins Lloyd's it is obliged to enter into several categories of trust deed to ensure that funds are available to pay policy-holders, and these are currently registrable as charges although most of the registrations serve little useful purpose.

Under the Regulations, the "Lloyd's Deposit Trust Deed" or "Lloyd's Security and Trust Deed" created by each corporate member will continue to be registrable. This will serve as a warning to all concerned that the company is a corporate member of Lloyd's and will probably have entered other trust deeds. Other trusts deeds will cease to registrable. Charges other than trust deeds created by corporate members will need to be registered in the normal way.

Regulation 4(1)(b)-(e) exempt from the scheme various types of sale of receivable that are not connected to receivables financing.

PART 2

REGISTRATION OF CHARGES AND SALES OF RECEIVABLES

The Register

5.—(1) The Registrar of Companies ("the Registrar") must establish and maintain a register of charges and of sales of receivables ("the register").

(2) An application for registration of a charge, or a sale of receivables, must be made by filing a financing statement that satisfies the requirements of these Regulations and the Rules.

(3) The person filing a financial statement must confirm that the charge or sale to which it relates has been made or that the debtor consents to the filing.

(4) A financing statement that does not meet the requirements of these Regulations or of the Rules may be rejected by the Registrar.

(5) A financing statement may also be rejected by the Registrar if—

(a) the prescribed filing fee is not paid, or

(b) an arrangement for paying the filing fee is not in place.

(6) In these Regulations—

"prescribed" means prescribed by the Rules,

"registered", in relation to a charge or a sale of receivables, means (except in the context of registration in a specialist register in regulation 25) that a financing statement relating to it—

(a) has been registered,

(b) is not ineffective because of regulation 9 (errors), and

(c) has not expired or been discharged,

and "unregistered" is to be read accordingly, and

"Rules" means rules made by the Registrar in accordance with section [x of the Companies Act 2006].

Financing statement

6.—(1) A financing statement—

(a) may be filed before or after the charge or sale to which it relates is made,

(b) may relate to more than one charge or sale, and

(c) must include the required information.

(2) The required information is—

(a) the name of the debtor,

(b) the debtor's registered number (if any),

(c) the name and address of the chargee or buyer, or its agent (if any),

(d) a description of the collateral,

(e) whether the filing is to continue indefinitely or until a specified date, and

(f) such other information as may be prescribed by the Rules.

(3) A financing statement may also disclose whether the chargee is a trustee.

(4) Paragraphs (2) and (3) are subject to regulation 9 (errors).

(5) In these Regulations—

"chargee" means a person in whose favour a charge is created, including a trustee or any other party who holds a charge for the benefit of another person;

EXPLANATORY NOTES

PART 2 REGISTRATION OF CHARGES AND SALES OF RECEIVABLES

Regulation 5 The Register

Regulation 5, with the remainder of Part 2, sets up a register for company charges and sales of receivables that can be wholly electronic. Part 2 will be supplemented by Rules to be made by the Registrar under powers to be conferred by the Company Law Reform Bill.

Registration will be effected by 'filing' a 'financing statement'. The way that this will work is described below.

Regulation 6 Financing statement

It is envisaged that the Rules will require a person wishing to register a charge or sale of receivables (who will normally be the chargee or buyer, or its agent) to contact Companies House to be authorised to use the system, if it has not done so before. (This may involve, for example, setting up payment arrangements and giving an email address that the Registrar may use for communicating with the person.)

The person will then 'file' a 'financing statement' on-line (either via the Company Security Register's website or under direct arrangements made by the Registrar and the filing party). The financing statement must contain information in each of the fields listed in regulation 6(2) and the confirmation required by regulation 5(3) must be given. It is envisaged that the system will provide an automatic check that both the name of the debtor and its registered number are given and that they match each other. If they do not, or if no number is given, the filing will not be accepted until the party filing either enters a matching name and number or confirms that the company is an oversea company that has not registered a branch or place of business in Great Britain.

Once this is done and arrangements have been made for payment of the fees, the system will accept the filing. The date and time will be recorded on the financing statement and it will be given a number. From that moment, the financing statement will be 'registered' (regulation 7(1)). Subject to regulation 9, the charge or sale will then be registered unless the registration ceases to be effective because it was for a limited period that has expired or because it has been discharged.

A filing may be made before the charge agreement or sale agreement has been made. This enables a financier engaged in negotiations with the company to protect its priority. It also makes it unnecessary to file more than once for repeated transactions with the same company over similar collateral. This is important in receivables financing, where there may be many separate sales under a single agreement that does not itself constitute a sale.

A party filing will be required to confirm that either there is a charge or sale agreement or the company has consented to the filing. An incorrect confirmation will expose the filing party to liability in damages to the company for any loss it suffers as a result, unless the party filing can show that it had a reasonable excuse for its mistake. A filing made without an honest belief that there is an agreement or that the company has consented to the filing will lead to criminal liability under general provisions envisaged in the Companies Bill. The company named as debtor will be able to secure the removal of any incorrectly-made filing under regulation 16.

"collateral" means—

(a) property subject to a charge or pledge, or

(b) receivables that have been sold,

"debtor" means—

(a) a company whose property is subject to a charge or pledge, whether to secure its own obligation or that of another,

(b) a company which sells receivables, or

(c) a transferee of, or successor to, a company falling within paragraph (a) or (b) of this definition, and

"registered number", in relation to a company, has the same meaning as in the [Companies Act 2006].

When registration is effective

7.—(1) A filed financing statement is registered when a date, time and number ("the financing statement number") are assigned to it by the Registrar.

(2) The financing statement number determines the order of registration in the event of two or more financing statements being registered with the same date and time.

(3) Registration continues to be effective—

(a) until it is discharged, or

(b) if the financing statement specifies a date on which registration is to end, and the registration has not by then been discharged, until that date.

(4) This is subject to regulation 9 (errors).

Verification statement

8.—(1) As soon as is reasonably practicable after registration of a financing statement, the Registrar must send a statement (a "verification statement") to—

(a) the person ("P") named in the financing statement as the chargee or buyer or its agent, and

(b) the debtor.

(2) But if the debtor is a foreign company which has not registered a place of business or branch in Great Britain under the [Companies Act 2006], the Registrar may instead require P to forward a copy of the verification statement to the debtor within 10 business days of receiving it.

(3) Paragraph 1(a) does not apply if P has notified the Registrar in writing that he does not require copies of verification statements.

(4) Paragraphs (1)(b) and (2) do not apply if the debtor has notified the Registrar in writing that he does not require copies of verification statements.

(5) A verification statement must include—

(a) the information contained in the financing statement,

(b) the financing statement number, and

(c) the date and time of registration.

EXPLANATORY NOTES

Regulation 7 When registration is effective

The financing statement is registered at the moment that the system assigns a number to it; the date and time will also be recorded. The date, time and (if necessary) the number will often determine questions of priority (for example, regulation 24).

Regulation 8 Verification statement

Once the financing statement has been registered, a verification statement will be sent to the person filing at the address given, and to the company identified as the debtor in the financing statement. In the case of a company registered in Great Britain or that has registered a branch or place of business in Great Britain, the 'verification statement' will be sent by the Registrar, either by email or by post, to the company's registered address (or such other address as the company may have provide for the purpose). In the case of other companies, the party filing will be obliged to send a copy of the verification statement to the company, and will be liable in damages to the company for any failure to do so (regulation 17(2)).

Errors in financing statement

9.—(1) The registration of a financing statement is ineffective to register a charge or sale if it contains a defect such that its existence would not be discovered by a reasonable search under regulation 15.

(2) But the registration is not otherwise affected by any defect in the financing statement.

(3) If the debtor has changed its name, the fact that a person searching under its previous name might not discover the existence of the financing statement does not, of itself, make the registration ineffective.

(4) Nothing in paragraph (1) requires a search to have been carried out.

(5) Failure to provide a description in a financing statement in relation to any collateral does not make the registration ineffective with respect to other collateral described in the financing statement.

(6) "Defect" includes an irregularity, omission or error.

Additional statements

10.—(1) In these Regulations "additional statement" means a statement that satisfies the requirements of these Regulations and the Rules and is filed by the chargee or buyer or its agent under—

(a) regulation 11 (extension or discharge of registration),

(b) regulation 12 (amendment of financing statement),

(c) regulation 13 (notice of transfer), or

(d) regulation 14 (notice of subordination),

or under regulation 16 (debtor etc may require additional statement).

(2) An additional statement that does not meet the requirements of these Regulations or of the Rules may be rejected by the Registrar.

(3) An additional statement may also be rejected by the Registrar if—

(a) the prescribed filing fee is not paid, or

(b) an arrangement for paying the filing fee is not in place.

Extension or discharge of registration

11.—(1) The registration of a financing statement may, at any time before it expires, be extended or discharged by filing an additional statement.

(2) A registration which is extended continues to have effect until—

(a) the date specified in the additional statement, or

(b) if earlier, the date on which the registration is discharged.

Amendment of financing statement

12.—(1) A registered financing statement may, at any time before it expires, be amended by filing an additional statement.

(2) The additional statement is registered when a date, time and number are assigned to it by the Registrar.

EXPLANATORY NOTES

Regulation 9 Errors in financing statement

The system will check that the name and number given for the debtor company match (see above). However, it will not check the accuracy of any other information on the financing statement. If the financing statement has identified the wrong company, it will not be effective to register the charge or sale of receivables. This is because a search using the correct name and number would not reveal it.

With oversea companies that have not registered a branch or place of business in Great Britain, it is envisaged that those searching the register will be able to ask for 'near misses'. A registered financing statement that gave an incorrect name will be effective to register the charge unless a search using the 'near miss' facility would not have revealed the financing statement.

A mistake in the other fields will not invalidate the registration save that the charge will not be effectively registered in respect of collateral that was omitted from the description of the collateral.

Regulation 10 Additional statements

Subsequent changes to a financing statement (such as to add or delete collateral or to discharge it altogether) will be made by filing an 'additional statement'. This will have to contain the number allocated to the financing statement that is being amended. A search will then reveal not just the original statement but any additional statements that have amended it. It is assumed that, after a while, discharged financing statements will be removed to an 'archive' file so that a search will not reveal them unless the searcher specifically asks for 'archived' material.

It is envisaged that the party who files will be issued with a personal identification number that will enable it to access the system to file additional statements. Where a party attempts to extend the period of registration or add to the security, it will be asked to confirm that this is in accordance with an existing security agreement or that the debtor has consented to the change. The sanctions will be as described under regulation 6, above.

In certain circumstances the debtor will also be able to effect changes by means of an additional statement (regulation 16).

Regulation 11 Extension or discharge of registration

Registration of a financing statement that was limited to run only until a particular date may be extended by the party who filed by means of an additional statement.

Regulation 12 Amendment of financing statement

See regulation 10, above.

Notice of transfer

13.—(1) If, in relation to a registered charge or registered sale, the chargee or buyer transfers an interest in collateral, an additional statement disclosing the transfer may be filed.

(2) For the avoidance of doubt, the transferee of a registered charge, or of receivables which are the subject of a registered sale, is not required to file an additional statement in order to continue the effectiveness of the registration against an administrator or liquidator or a person mentioned in regulation 20(4) or 36(2) (execution creditors etc).

(3) If an additional statement is filed under paragraph (1), and an interest in part of the collateral is transferred, the statement must include a description of the collateral in which the interest is transferred.

(4) If, in relation to an unregistered charge or sale of receivables, the chargee or buyer transfers an interest in collateral, a financing statement may be filed in which the transferee is disclosed as the chargee or buyer.

(5) An additional statement disclosing a transfer of a charge or of the sale of receivables may be filed before or after the transfer.

(6) Once an additional statement is registered, the transferee is to be treated as the chargee or buyer for the purposes of these Regulations.

Notice of subordination

14.—(1) If a charge or sale of receivables has been subordinated by the chargee or buyer to the interest of another person, an additional statement may be filed disclosing the subordination.

(2) The additional statement may be filed at any time before the registration of the financing statement relating to the charge or sale expires.

Searches

15.—(1) Any person may search the register, subject to any condition or exception imposed by the Rules, including in particular any requirement to pay a prescribed fee.

(2) The register must be organised so as to permit searches using one or more of the following criteria—

(a) the name of the debtor,

(b) the registered number of the debtor (if any),

(c) the financing statement number,

and any additional criteria permitted by the Rules.

(3) A search result that purports to be authorised by the Registrar, whether printed by the Registrar or by any other person, may be received in evidence as prima facie proof of its contents.

EXPLANATORY NOTES

Regulation 13 Notice of transfer

Where a charge is assigned by the chargee to another person, it is not necessary to file an additional statement. However, it may be convenient for all concerned that the new assignee is recorded as the chargee so that enquiries and notices are sent direct to it. The same is true if the benefit of an agreement to sell receivables is assigned, for example by one factor to another. It is therefore provided that the transfer may be recorded.

Regulation 14 Notice of subordination

The same is provided where the parties enter a subordination agreement.

Regulation 15 Searches

Regulation 15 provides for searches, including the criteria by which searching must be made possible. For the significance of this see regulation 9, above.

Debtor etc may require additional statement

16.—(1) If—

(a) a financing statement is registered, and

(b) one of the conditions set out in column 1 of the Table is satisfied,

the debtor, or any person with an interest in property which falls within the description of the collateral in the financing statement, may give a notice in writing (a "requirement notice") to the person ("P") named in the financing statement as chargee, buyer or its agent.

(2) The requirement notice must—

(a) specify the condition which is satisfied,

(b) require P to file an additional statement with the effect indicated in column 2 of the Table relating to that condition, and

(c) inform P that failure to comply with the requirement notice may result in the person who gives the notice filing the appropriate additional statement.

Table

Additional statements

1. Condition	*2. Effect*
That the obligations under all of the charge agreements or sale agreements to which the financing statement relates have been performed.	To discharge the registration.
That the chargee or buyer has agreed to release part or all of the collateral described in the financing statement.	To amend or discharge the registration so as to reflect the terms of the agreement.
That the description of the collateral in the financing statement includes an item or kind of property that is not collateral under a charge agreement or sale agreement between the chargee or buyer and the debtor.	To amend the collateral description to exclude items or kinds of property that are not collateral under a charge agreement or sale agreement between the chargee or buyer and the debtor.
That no charge agreement or sale agreement exists between the persons named in the financing statement as the chargee or buyer and the debtor.	To discharge the registration or, where that debtor is not the sole debtor, to amend the registration.

(3) If the person who gives a requirement notice is not the sole debtor, he must give a copy of the requirement notice to every other debtor to whom the financing statement relates within 5 business days of the requirement notice being given to P.

(4) The person who gives a requirement notice may file an additional statement as requested in the requirement notice if P does not, within 15 business days after the notice is issued—

(a) comply with the requirement notice, or

(b) commence proceedings in the appropriate court for an order to maintain the registration to which the notice relates and notify the person who gave the requirement notice and the Registrar accordingly.

EXPLANATORY NOTES

Regulation 16 Debtor etc may require additional statement

If the information shown in a registered financing statement is inaccurate (for example it refers to collateral not covered by the charge agreement), the debtor may demand that it be corrected. Similarly if the secured obligations have been discharged, the debtor may demand that the financing statement be discharged. If the company shown as the debtor has not entered a charge agreement with the person who is named as the chargee, or on whose behalf the financing statement was filed, it can demand that the registration be removed. Where the person was incorrectly identified as one of several debtors, the person wrongly identified can have its name removed, leaving in place the registration against other parties who were correctly named as debtors.

It is envisaged that in most cases the debtor will make its demand by entering on the system a 'requirement' notice, setting out what change is required. This will be sent to the party shown as chargee, or its agent, on the financing statement at the address shown. Within 15 days the recipient must either file an additional statement in accordance with the requirement notice or commence court proceedings and notify the Registrar that it has done so. Failing that, the debtor will be empowered to make the change demanded in the requirement notice. If proceedings have been commenced, the Registrar will mark the financing statement as contested. The financing statement will remain registered until the Registrar is notified of the court's order. However, where 90 days (or such longer period as the court may order) elapses without an order being obtained or the proceedings are dismissed or discontinued, the debtor will be empowered to make the change demanded.

Where the chargee is merely a trustee for others (for example, for a group of lenders), the procedure will not apply, because an oversight by the trustee might lead to the beneficiaries losing their security through no fault of their own. If the financing statement indicates that the chargee is a trustee (which will be optional), the person named as debtor will need to obtain a court order to have the financing statement amended or discharged.

(5) If the Registrar is notified under paragraph (4)(b) of the commencement of proceedings, he must, as soon as reasonably practicable, amend the register to show that the registration is the subject of a dispute.

(6) On an application by P to the appropriate court, the court may order that the registration—

(a) be maintained on any condition and for any period of time that the court considers appropriate, subject to regulations 7(3), 11(2) and 12 (duration, extension and amendment), or

(b) be discharged or amended.

(7) If a court order is not obtained within 90 business days of the commencement of proceedings or such longer period as the court may direct, the person who gave the requirement notice may file an additional statement as requested in the requirement notice as if P had not complied with paragraph (4).

(8) Paragraphs (4) to (7) do not apply to a trust case.

(9) In a trust case, the appropriate court may, on an application by the person giving the requirement notice, make an order directing that the registration be amended or discharged if—

(a) one or more of the conditions in paragraph (2) are satisfied, and

(b) the chargee or its agent does not comply with the requirement notice within 25 business days after the notice is issued;

and the court may make such other orders as it thinks proper for the purpose of giving effect to the order.

(10) In this regulation—

"the appropriate court" has such meaning as may be prescribed;

"trust case" means a case in which the financing statement discloses that the chargee is a trustee.

(11) Notices under this regulation must be given in the prescribed form and manner.

Entitlement to damages for incorrect filing etc

17.—(1) If a person (without having a reasonable excuse)—

(a) files a financing statement confirming the existence of a charge agreement or sale agreement which does not in fact exist, or

(b) files a financing statement confirming that the debtor has consented to the filing when the debtor has not in fact consented,

the debtor has a right to recover damages from him for any loss or damage that was reasonably foreseeable as likely to result from the filing.

(2) If a person (without having a reasonable excuse) fails to forward a copy of the verification statement to the debtor within 10 business days of receiving it as required under regulation 8(2) (verification statement), the debtor has a right to recover damages from him for any loss or damage that was reasonably foreseeable as likely to result from the filing.

EXPLANATORY NOTES

Regulation 17 Entitlement to damages for incorrect filing, etc

If a financing statement has been filed when there is no relevant agreement or the debtor has not consented to the filing, and the party filing had no reasonable excuse, the party who filed will be liable in damages to the company identified as the debtor.

A party who files a financing statement against a company that is not registered, and has not registered a branch or place of business in Great Britain, must forward the verification statement to the company (regulation 8). If it fails to do so without a reasonable excuse it will be liable in damages to the company.

Requirement to notify Registrar about appointment of receiver

18.—(1) A person who—

(a) obtains an order for the appointment of a receiver or manager of a company's property, or

(b) appoints a receiver or manager of a company's property under powers contained in an instrument,

must notify the Registrar of that fact within 7 days of the order or appointment.

(2) A receiver or manager of a company's property appointed under powers contained in an instrument who ceases to act as such must, on so ceasing, notify the Registrar.

(3) The Registrar must enter information notified under paragraph (1) and (2) in the register.

(4) A notice under this section must be in the prescribed form and manner.

(5) A person who fails to comply with this regulation is guilty of an offence and liable on summary conviction to a fine not exceeding level 3 and to a fine not exceeding one-tenth of that level for each day on which the failure continues.

Filing is not notice

19.—(1) The filing of a financing statement or additional statement does not constitute notice or knowledge of its existence or contents to any person.

(2) A purchaser of collateral is not required to enquire whether—

(a) the collateral has been charged or pledged or, in the case of receivables, sold, or

(b) whether the disposition constitutes a breach of the terms of the charge.

EXPLANATORY NOTES

Regulation 18 Requirement to notify Registrar about appointment of a receiver

This provision replicates the effect of the Companies Act 1985, section 405.

Regulation 19 Filing is not notice

Some provisions (regulations 21, 24, 28, 29, 35 and 38) refer to whether a party knew of a fact. Regulation 19 has the effect that registration of a financing statement does not give anyone 'constructive' notice of the existence of any charge to which it refers, or of the contents of the financing statement. Under the regulations, the priority of a registered charge against another registered charge or a pledge, for example, generally depends on the date of registration. Its effect against a buyer depends on whether it was registered and on the buyer's knowledge. In neither case does the outcome depend on 'constructive notice' of what has been registered.

PART 3

EFFECTIVENESS OF CHARGES ETC

Effectiveness of charge or sale of receivables in insolvency proceedings

20.—(1) A charge or a sale of receivables is not effective against an administrator or liquidator unless, before the onset of insolvency,—

(a) it is registered,

(b) in the case of a supporting obligation, the charge over the obligation it supports is registered,

(c) in the case of a right to the proceeds of collateral arising other than only as a result of the terms of a floating charge, if the charge over the original collateral is registered, or

(d) in the case of a charge over sums due under a letter of credit, regulation 26(5) is satisfied.

(2) Paragraph (1) does not apply in the case of a sale of receivables if the sale (by itself or in conjunction with other sales to the buyer) is of such a small proportion of the assignor's receivables that it would not influence a reasonable person deciding whether to make an advance to the company; and for the purposes of Part 4 (priority) such a sale of receivables is to be treated as having been registered at the date of the sale.

(3) "Onset of insolvency" means—

(a) if an administrator of a company is appointed by administration order, the date on which the administration application is made,

(b) if an administrator of a company is appointed under paragraph 14 or 22 of Schedule B1 to the Insolvency Act 1986(**a**) (appointment of administrator by the holder of a qualifying floating charge, or by the company or its directors) following filing with the court of a copy of a notice of intention to appoint under that paragraph, the date on which the copy of the notice is filed,

(c) if an administrator of a company is appointed otherwise than under sub-paragraph (a) or (b), the date on which the appointment takes effect,

(d) if a company goes into liquidation, the date of the commencement of the winding-up.

(4) A charge or interest arising under a sale of receivables is subordinate to the interest of a person—

(a) who causes the collateral to be seized in accordance with due process to enforce a judgment, including execution, attachment or garnishment, or

(b) who has obtained a charging order or equitable execution which affects or relates to the collateral,

unless the charge or sale falls within paragraph (1)(a) to (d) at the time that person's interest arises.

(5) This regulation does not apply to charges to which regulation 36 applies (effectiveness of charge over investment property or cash in insolvency proceedings).

Charges over imported goods

21.—(1) Paragraph (2) applies to a charge over imported goods—

(a) created by a company registered in Scotland or a foreign company, and

(b) perfected under the law of any jurisdiction in which the goods were located ("the first jurisdiction") before being imported.

(**a**) 1986 c. 45.

EXPLANATORY NOTES

PART 3 EFFECTIVENESS OF CHARGES, ETC

Regulation 20 Effectiveness of a charge or a sale of receivables in insolvency proceedings

Unless a charge is exempt from registration, it will not be effective against the company's administrator or liquidator unless it has been registered before the onset of insolvency (regulation 20(1)). The charge will also be ineffective as against execution creditors (regulation 20(4)). (It will also be at risk of loss of priority to subsequent charges and pledges and ineffective against a buyer who does not know of it, see regulations 24 and 28. On charges that are registered in the 'run-up to insolvency', see regulation 45.)

A charge of any description and over any type of property falls within this regulation unless specifically exempted. The principal exemptions are for charges over:

- financial collateral of which the chargee has 'control' (see regulation 36);
- registered land where the charge has been registered at the Land Registry (see regulation 4); and
- 'supporting obligations' such as guarantees and letters of credit, which will be treated as if they are registered when the charge over the principal obligation has been registered.

If as the result of the debtor company disposing of the collateral the chargee becomes entitled to the proceeds of disposition, its rights to the proceeds will be effective without separate registration (unless its right arises only because of the terms of a floating charge). The same applies if the collateral is damaged or destroyed and the chargee is entitled to the insurance proceeds (regulation 20(1)(c)).

The scheme extends the same treatment to sales of receivables. (For the definition of receivables see regulation 2.) There is one exception, to guard against accidental oversight by those not regularly engaged in receivables financing. Under regulation 20(2) it is not necessary to register a sale of receivables that is of such a small proportion of the company's receivables that its sale will not be significant to the decision of a subsequent receivables financier or unsecured creditor as to the extent of funds or credit that should be advanced to the company.

Regulation 21 Charges over imported goods

Under regulation 3, charges created by Scottish and oversea companies over their assets in England and Wales will be subject to the scheme. When goods that are subject to a charge are brought into the jurisdiction, the charge will need to be registered if they remain here for more than 60 days. Otherwise it will be ineffective in the Scottish or oversea company's insolvency. Until the charge has been registered, it will be vulnerable to loss of priority and will be ineffective against a buyer who does not know of it (regulations 24 and 28). Special treatment is accorded to registered aircraft and registered ships (regulation 3).

(2) For the purposes of these Regulations, a charge remains effective against an administrator or liquidator or a person mentioned in regulation 20(4) or 36(2) (execution creditors etc) if it is registered—

(a) not later than 60 business days after the day on which the goods were imported, or

(b) before perfection ceases under the law of the first jurisdiction,

whichever is the earlier.

(3) For the purposes of Part 4 (priority), a charge which remains effective under paragraph (2) has priority from the date on which it was first perfected under the first jurisdiction.

(4) But a charge which remains effective under paragraph (2) is subordinate to the interest of a transferee (other than a chargee or pledgee) who takes possession or delivery of the goods—

(a) after the goods have been imported,

(b) without knowledge of the charge, and

(c) before the charge is registered.

(5) "Imported" means brought into England and Wales.

(6) "Perfected", in relation to a charge, means that all necessary steps have been taken to render it effective against third parties and in insolvency proceedings under the law of the jurisdiction in question; and "perfection" has a corresponding meaning.

Pledge treated as charge if collateral made available to debtor

22.—(1) This regulation applies to a pledge of a negotiable instrument (including a certificated financial instrument in bearer form) which the pledgee delivers to the debtor for the purpose of –

(a) sale or exchange,

(b) presentation, collection, enforcement, renewal, or registration of a transfer.

(2) This regulation also applies to a pledge of—

(a) a negotiable document of title to goods, or

(b) goods held by a bailee which are not covered by a negotiable document of title,

if the pledgee makes the document of title or goods available to the debtor for any of the purposes mentioned in paragraph (3).

(3) The purposes are—

(a) sale or exchange,

(b) loading, unloading, storing, shipping, transhipping, manufacturing, processing, packaging or otherwise dealing with goods in a manner preliminary to their sale or exchange.

(4) For the period during which the collateral is made available to the debtor, a pledge to which this regulation applies and any right of the pledgee to the proceeds of disposition of the collateral is treated as a charge over the collateral and its proceeds which, for the first 15 business days of that period, need not be registered to be effective against an administrator or liquidator or a person mentioned in regulation 20(4) or 36(2) (execution creditors etc).

(5) For the purposes of Part 4 (priority) and without prejudice to regulation 39 (special priority rules for investment property and cash), a pledge to which this regulation applies has priority from the date it was created if—

(a) the collateral is returned or the proceeds transferred to the pledgee within the 15 day period mentioned in paragraph (4), or

(b) it is registered as a charge within that 15 day period and remains registered until the collateral is returned or the proceeds transferred to the pledgee.

EXPLANATORY NOTES

Regulation 22 Pledge treated as charge if collateral made available to debtor

Although generally a pledge requires that the pledgee retain possession of the pledged property, it has been held that if the property is released to the debtor under a 'trust receipt' or similar arrangement (for instance to allow the debtor to sell the property) the pledge continues. The pledgee is also entitled to the proceeds of any disposition the property. Regulation 22 treats such arrangements as a charge which, if it is to be effective in the debtor company's insolvency, must be registered within 15 days (unless the property is returned to the pledgee within that time). Until the charge has been registered (which may be done in advance of the arrangement, see regulation 6), a buyer who does not know of it will take free of it (regulation 28) and it will be vulnerable to loss of priority (see regulation 24).

Attornment by debtor

23. These Regulations apply to a pledge under which the debtor has possession of collateral and attorns to the pledgee as if the pledge were a charge.

PART 4

PRIORITY

Priority rules

Residual rules

24.—(1) The following provisions apply if these Regulations do not otherwise determine priority between conflicting charges, sales of receivables and pledges.

(2) A registered charge or sale of receivables has priority over an unregistered charge or sale of receivables.

(3) Priority between registered charges and registered sales of receivables is determined by the order of registration of the relevant financing statements.

(4) Priority between unregistered charges and unregistered sales of receivables is determined by the order of creation or sale.

(5) Priority between a charge and a pledge is determined by whether the financing statement relating to the charge is registered before the pledge is created.

(6) A transferee of a charge or pledge acquires the same priority with respect to the charge or pledge as the transferor had at the time of transfer.

(7) A charge over, or sale of, a supporting obligation has the same priority as the charge over, or sale of, the principal obligation which it supports.

(8) Any right to the proceeds of collateral arising other than only as a result of the terms of a floating charge has the same priority as the charge over the original collateral.

(9) A registered charge over crops growing on land has priority over a conflicting interest in the land if the debtor has an interest in or is in occupation of the land.

(10) The priority that a charge, pledge or sale of receivables has under this regulation applies to all advances, including future advances, whether or not made under an obligation.

(11) Paragraph (10) applies to give a registered charge or a pledge priority over the interests of persons mentioned in regulation 20(4) (execution creditors etc) only to the extent of—

(a) advances made before—

(i) the interests of those persons arise, or

(ii) those persons seize the collateral or obtain a right to it,

(b) advances made before the chargee or pledgee acquires knowledge of the interests of those persons,

(c) advances made under—

(i) a statutory requirement, or

(ii) a legally binding obligation which was entered into by the chargee or pledgee before acquiring the knowledge mentioned in sub-paragraph (b), and

(d) such costs and expenses as were provided for in the charge or pledge agreement or, in the absence of such agreement, reasonable costs and expenses incurred by the chargee or pledgee for the protection, preservation, maintenance or repair of the collateral.

(12) For the purposes of this regulation, the priority of a contractual lien dates from—

(a) the agreement for the lien, or

(b) the date on which the goods come into possession of the lienee,

Regulation 23 Attornment by debtor

A pledgee may take 'possession' of property that is in the physical possession or custody of a third person (for example, a warehousing company) if the third person agrees with the pledgee to hold to its order ('attorns' to the pledgee). There is authority that there may be a pledge where the debtor itself has physical possession or custody and attorns to the pledgee. (If the arrangement is in writing it is registrable as a bill of sale.) The arrangement may mislead others dealing with the debtor into believing that the property in the debtor's possession is unencumbered and under these Regulations it is treated as a charge.

PART 4 PRIORITY

Priority rules

Regulation 24 Residual rules

Regulation 24 sets out the rules that govern priority between charges and pledges over property other than financial collateral (regulation 36) and sums due under letters of credit (regulation 26). The rules also apply to the priority of sales of receivables. The fundamental principles are that priority of a charge or a sale of receivables dates from the date of registration of a financing statement covering the charge or sale. This may be before the charge has been created or the sale has taken place (regulation 6). The priority of a pledge dates from when it was created, which requires that the pledgee has possession (regulations 22 and 23). For this purpose, a contractual lien is considered to be a pledge (regulation 42). Charges over supporting obligations that have not been registered separately will have the same priority as the charge over the principal obligation.

The priority of a charge will apply to all advances made under the charge, including those made after the chargee has notice of a subsequent charge. This is not confined to advances that the chargee is under an obligation to make. However advances made without any obligation to do so after the chargee has notice of the interests of an execution creditor will not have priority over the interests of the execution creditor (regulation 24(11)).

Priority from date of registration of the financing statement will apply to floating charges as well as fixed charges, so that it will no longer be necessary to employ negative pledge clauses to protect the priority of a floating charge. Consequential amendments will be made to Insolvency Act 1986 to clarify the effect on preferential creditors and the fund for unsecured creditors (see regulation 45).

whichever is later.

(13) "Advance" means the payment of money, the provision of credit or other giving of value, and includes any entitlement to interest, credit costs and other charges or costs payable in connection with an advance or the enforcement of a charge or pledge securing the advance.

Conflict with transactions registered in specialist registers

25.—(1) Any conflict between—

(a) a registered or unregistered charge, and

(b) a transaction which is registered in a specialist register,

is to be determined in accordance with the priority rules in the enactments governing the specialist register, subject to paragraphs (2) to (4).

(2) If the conflict is between—

(a) a floating charge created by a company over unregistered land and any other charge over the same land, or

(b) a floating charge created by a company over registered land and any other transaction over the same land except a legal purchase,

the floating charge has priority if the financing statement relating to it was registered under these Regulations before the competing transaction was registered in the specialist register or the financing statement relating to it was registered under these Regulations.

(3) If the conflict is between a fixed equitable charge created by a company over registered land and any other transaction over the same land other than a legal mortgage or other legal purchase, the fixed equitable charge has priority if it was registered in the specialist register or the financing statement relating to it was registered under these Regulations before the competing transaction was registered in the specialist register or the financing statement relating to it was registered under these Regulations.

(4) Paragraphs (2) and (3) are without prejudice to sections 28 to 30 of the Land Registration Act 2002(**a**) (effect of dispositions on priority) and rules 147 to 154 of the Land Registration Rules 2003(**b**) (official searches with priority).

(5) "Specialist register" means a register established under any of the following enactments—

(a) the Land Charges Act 1972(**c**),

(b) the Land Registration Act 2002,

(c) the Merchant Shipping Act 1995(**d**),

(d) the Mortgaging of Aircraft Order 1972(**e**),

(e) the Patents Act 1977(**f**),

(f) the Registered Designs Act 1949(**g**), and

(g) the Trade Marks Act 1994(**h**).

(**a**) 2002 c.9.
(**b**) S.I. 2003/1417.
(**c**) 1972 c. 61.
(**d**) 1995 c. 21.
(**e**) S.I. 1972/1268.
(**f**) 1977 c. 37.
(**g**) 1949 c. 88.
(**h**) 1994 c. 26.

EXPLANATORY NOTES

Regulation 25 Conflict with transactions registered in specialist registers

Charges over certain types of asset may be registered in specialist registers. These include:

- registered aircraft
- registered ships
- unregistered land (for registered land, see below)
- patents
- registered designs
- registered trademarks.

Registration in the specialist register is not required to preserve the effectiveness of the charge in the debtor company's insolvency. However, it may be needed to create a legal mortgage or to preserve the priority of an equitable mortgage or charge against a subsequent purchaser or chargee. In these cases, the charge will also have to registered in the Company Security Register if it is to be effective in the debtor company's insolvency. Regulation 25 provides that the priority of charges over such assets will be governed by any rules set out in the relevant enactment rather than by the date of registration in the Company Security Register.

Regulation 25 applies the same rule to charges over registered land registered in the Land Register, which do not require registration in the Company Security Register (regulation 4).

In some cases the enactment establishing the specialist registry does not lay down rules governing the priority of charges registered in it but leaves it to general law. For example, the priority of equitable charges over registered land is not affected by registration at the Land Registry. Here the rules of the Company Security Regulations will apply. Thus as between two equitable charges over registered land, if neither charge is registered at the Land Register, priority will depend on which financing statement was first registered in the Company Security Register. If one is covered by a financing statement registered in the Company Security Register and the other is registered in the Land Register, priority will depend on which registration took place first.

Sums due under letters of credit

26.—(1) The following provisions govern priority between conflicting charges over the same sums due under a letter of credit.

(2) A charge held by a chargee who has command of the sums due under the letter of credit has priority over a conflicting charge held by a chargee who does not have command.

(3) Conflicting charges under which each chargee has command rank according to priority in time of obtaining command.

(4) In all other cases, priority among conflicting charges in the same sums due under a letter of credit is governed by regulation 24 (residual priority rules).

(5) A chargee has command of the sums due under a letter of credit to the extent of any right to payment or performance by the issuer or any nominated person—

(a) where the issuer or nominated person is bound or compelled under any enactment, instrument or rule of law to receive notice of an assignment or charge, if the chargee has notified the issuer or nominated person of its assignment of, or fixed charge over, the sums due under the letter of credit, or

(b) if the issuer or nominated person is not so bound or compelled, the chargee has obtained the agreement of the issuer or nominated person that the debtor will no longer be able to deal with the sums due under the letter of credit without the agreement of the chargee.

(6) "Nominated person" means a person whom the issuer—

(a) designates or authorises to pay, accept, negotiate or otherwise give value under a letter of credit, and

(b) undertakes by agreement or custom and practice to reimburse.

Transfers

Priority of charges in transferred collateral

27.—(1) If the debtor acquires property subject to a charge ("charge A") created by a company other than the debtor, charge A has priority over any charge over the same property created by the debtor if—

(a) charge A was registered when the debtor acquired the collateral, and

(b) there is no period after the debtor acquired the collateral when charge A was not registered.

(2) If the debtor acquires property subject to a charge created by a person who is not a company, that charge has priority over any charge over the same property created by the debtor.

(3) Paragraphs (1) and (2) are subject to regulations 30 (protection of transferees of money, negotiable instruments etc), 38 (purchaser takes free: investment property) and 39 (special priority rules for investment property and cash).

Transfer of collateral free of unregistered charge

28.—(1) A transferee of collateral subject to an unregistered fixed charge who—

(a) gives value, and

(b) if the collateral is tangible, takes possession or delivery of it,

takes free of the charge unless he has knowledge of its existence.

(2) For the purposes of paragraph (1), a transferee of a negotiable instrument or the holder of a negotiable document of title, who acquired the negotiable instrument or negotiable document of title in a transaction which was in the ordinary course of the transferor's business, has knowledge of the charge only if the transferee or holder acquired the interest with knowledge—

(a) of the existence of the charge, and

EXPLANATORY NOTES

Regulation 26 Sums due under letters of credit

A charge may be taken over an obligation that is supported by a letter of credit. The chargee has an implied right to the sums due under the letter of credit and the scheme provides that the charge over these need not be registered separately from the charge over the principal obligation. Under regulation 24 above, the charge over the supporting obligation will have the same priority as that over the principal obligation. However it is possible that the principal obligation may be subject to competing charges (probably by accident, for example if the company assigns a particular receivable forgetting that it is already the subject of a general charge over receivables, or vice versa). In this rather particular context, regulation 26 provides that the chargee who notifies the issuing bank or the confirming bank (a 'nominated person') will have priority over one who has relied merely on registering the charge. The bank will normally have to pay the sum due to the party that first notified it; regulation 26 ensures that this will be the party who has priority.

Transfers

Regulation 27 Priority of charges in transferred collateral

If a company acquires property that is subject to a charge, that charge will still be effective though it is not registered against the name of the acquiring company (provided that, if the charge was originally created by another company, the charge was registered against that company). Regulation 27 ensures that the charge will have priority over any charge that already exists, or that is created later, over the property of the acquiring company. (There is in effect an exception in those cases related to financial collateral in which the chargee's interests may be overriden in order to preserve the ready transferability of financial collateral, see regulation 38.)

Regulation 28 Transfer of collateral free of unregistered charge

A purchaser of property that is subject to a charge (other than a purchaser by way of security and a buyer of receivables: see regulation 28(5)(b) and regulation 24 above) will take free of an unregistered charge unless the purchaser knows of the charge. If the charge is a floating charge, the purchaser will take free unless it also knows that disposition is in breach of the charge (regulation 28(3)), and the same rule is applied to transferees of negotiable instruments and negotiable documents of title in order to maintain their ready transferability (regulation 28(2)).

(b) that the transaction is in breach of the terms of the charge.

(3) A transferee of collateral subject to a unregistered floating charge, who acquired the collateral in a transaction which was in the ordinary course of the transferor's business, takes free of the charge unless the transferee knew that the transfer was in breach of the terms of the floating charge.

(4) Paragraph (3) applies regardless of whether the charge was, as created, a floating charge or a fixed charge.

(5) For the purposes of this regulation—

(a) a charge falling within regulation 20(1)(b) or (c) or regulation 36(1)(e) or (f) (supporting obligation and proceeds) is to be treated as registered;

(b) "transferee" does not include chargee, pledgee or buyer of receivables.

(6) This regulation does not apply to a transfer which is in total or partial satisfaction of a money debt or antecedent liability.

Circumstances in which transferee takes collateral free of registered charge

29.—(1) A transferee of collateral subject to a registered charge which is a fixed charge takes subject to the charge unless the chargee has authorised the transfer.

(2) A transferee of collateral subject to a registered charge which—

(a) as created was a floating charge, or

(b) as created was a fixed charge but has become a floating charge,

and who acquired the collateral in a transaction which was in the ordinary course of the transferor's business, takes free of the charge unless the transferee knew that the transfer was in breach of the terms of the floating charge.

(3) For the purposes of this regulation—

(a) a charge falling within regulation 20(1)(b) or (c) or regulation 36(1)(e) or (f) (supporting obligation and proceeds) is to be treated as registered;

(b) "transferee" does not include chargee, pledgee or buyer of receivables.

(4) This regulation does not apply to a transfer which is in total or partial satisfaction of a money debt or antecedent liability.

Protection of transferees of money, negotiable instruments etc

30. Nothing in these Regulations affects the rights of a transferee of—

(a) money or other form of payment, or

(b) a negotiable instrument or negotiable document of title.

Miscellaneous

Priority: liens

31. Any lien which arises by operation of law takes priority over a charge, whether or not registered.

Distress for rent or rates

32.—(1) A landlord's right to distrain on goods for unpaid rent takes priority over any charge, whether or not registered.

Regulation 29 Circumstances in which transferee takes collateral free of registered charge

A buyer of the property subject to a registered charge will take subject to the charge unless the disposition is specifically authorised or the charge is a floating charge. The buyer of property subject only to a floating charge will take free unless it knows that the sale is in breach of the charge. In practice this will rarely happen unless a receiver has been appointed or the company has ceased trading or is in administration or liquidation.

Regulation 29 applies to a charge that was created as a floating charge. There is some uncertainty over what happens if a chargee takes a fixed charge and then permits the chargor to dispose of the property without obtaining consent on each occasion. This may make the fixed charge wholly ineffective or it may transform it into a floating charge. Regulation 29(2)(b) covers the latter possibility.

Regulation 30 Protection of transferees of money, negotiable instruments etc

This saving provision preserves the protection the law currently provides to recipients of money and funds transfers, holders in due course of negotiable instruments and holders of negotiable documents of title.

Miscellaneous

Regulation 31 Priority: liens

This preserves the current rule that a lien or charge that arises by operation of law has priority over a charge over the same property.

Regulation 32 Distress for rent or rates

Regulation 32(1) preserves the priority of a landlord's right to distrain on goods over a charge on the same goods. Regulation 32(2) provides that a local authority's rights to distrain on goods for unpaid rates will be subject to a registered charge. Under current law the local authority is in principle entitled to distrain if the charge is a floating charge that has not crystallised. In practice the floating charge will normally include an 'automatic crystallisation clause', causing the charge to crystallise as soon as any attempt is made to distrain. Such clauses defeat the local authority's right. Thus this Regulation reflects the practical position.

(2) A registered charge has priority over a local authority's right to distrain on goods for unpaid rates under Part 3 of the Non-Domestic Rating (Collection and Enforcement) (Local Lists) Regulations 1989(**a**) (or any equivalent regulations replacing Part 3).

Effect on priority of mistaken discharge of filing

33.—(1) This regulation applies if registration of a charge or a sale of receivables is discharged by mistake or without authorisation.

(2) If the chargee or buyer renews the registration in accordance with the Rules within 30 business days after the discharge, the discharge does not affect the priority ranking of the charge or sale to which the discharged registration relates as against a competing registered charge or sale which, immediately before the discharge, had a subordinate priority ranking.

(3) But paragraph (2) does not apply to the extent that the competing registered charge or sale secures advances made or contracted for after the discharge and before renewal of the registration.

Voluntary subordination

34.—(1) These Regulations do not preclude subordination by a person entitled to priority.

(2) But subordination does not, of itself, create a charge.

Rights of assignees

35.—(1) In this regulation, "assignee" includes a chargee, buyer of receivables and a receiver.

(2) Unless an account debtor has made an enforceable agreement not to assert defences to claims arising out of a contract, the rights of an assignee of the receivables are subject to—

(a) the terms of the contract between the account debtor and the assignor and any defence or claim arising from the contract or a closely connected contract, and

(b) any other defence or claim of the account debtor against the assignor which accrues before the account debtor acquires knowledge of the assignment.

(3) Any payment made by the account debtor to the assignor before receiving notice of the assignment of receivables discharges his obligation to the extent of the payment.

(4) Payment by an account debtor to an assignee in accordance with a notice mentioned in paragraph (3) discharges the obligation of the account debtor to the extent of the payment.

(5) A term in a contract between an account debtor and an assignor which prohibits or restricts assignment of the whole of the receivables for money due or to become due—

(a) is binding on the assignor, but only to the extent of making the assignor liable in damages for breach of contract, but

(b) is ineffective against assignees.

(**a**) SI 1989/1058; Part III was amended by the Non-Domestic Rating (Collection and Enforcement) (Local Lists) (Amendment) (England) Regulations 2003 (SI 2003/2210).

EXPLANATORY NOTES

Regulation 33 Effect on priority of mistaken discharge of filing

It is possible that a registered financing statement may be discharged by accident, either by the secured party or by an agent acting for it. That will have the result that the charge will not be effective in insolvency or affect a buyer. It will also lose priority to any subsequently registered charge. However, if the mistake is picked up and corrected within a short period, it seems harsh that the chargee should lose its priority even against charges that, before the discharge, were subordinate to it. Those chargees are very unlikely to have acted in reliance on the discharge. Therefore regulation 33 provides a 30-day grace period in which the discharged filing can be re-activated (by means of a further additional statement) without loss of priority as against the previously subordinate charges. This is without prejudice to further advances made before the re-activation (regulation 33(2)).

Regulation 34 Voluntary subordination

The purpose of regulation 34 is to make it clear that it is always possible for a chargee to subordinate its rights to what would otherwise be a junior charge (or sale of receivables). This may be done, for example, by an agreement between the senior and junior creditors; or the charge agreement may permit the creation of charges that will rank above it in priority.

Consequential amendments will be made to Insolvency Act 1986 to clarify the effect of a subordination agreement on preferential creditors and the fund for unsecured creditors. See the notes to regulation 45.

Regulation 35 Rights of assignees

Regulation 35(1)-(4) ensure that the new rules of priority do not affect the existing law

(1) on when an account debtor may, as against an assignee, rely on defences and set-offs that it has against the assignor; and

(2) that a debtor who pays the assignor before it has received notice of the assignment will discharge its obligation by doing so, but after receiving notice of assignment must pay the assignee.

Regulation 35(5) applies to contracts that create receivables, defined narrowly to cover only those debts commonly subject to factoring or discounting agreements. The regulation provides that a term in the contract purporting to prohibit or restrict assignment of the receivable (other than an assignment in part) will not be effective against the assignee. This removes a common (but often unintentional) obstacle to receivables financing.

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EXPLANATORY NOTES

PART 5 FINANCIAL COLLATERAL

This Part applies only to financial collateral, which needs separate treatment in order:

(1) to comply with the requirements of the European Directive on Financial Collateral Arrangements[2] ('the Financial Collateral Directive' or 'FCD') and the Financial Collateral Arrangements (No 2) Regulations 2003[3] ('FCAR') which implement the FCD, and

(2) to ensure that investment property is freely transferable without the need for the purchaser (whether intending buyer or secured party) to make investigations as to whether the property is subject to a charge.

In outline, the FCD provides that when financial collateral subject to a 'security financial collateral arrangement' (that is, a mortgage, charge or pledge) has been 'provided' in such a way as to be in the 'possession or control' of the 'collateral-taker', formalities such as registration cannot be required in order to render the arrangement enforceable (art 3).

(The FCD also requires that certain remedies must be available (unless otherwise agreed) and remain so notwithstanding winding-up or re-organisation of either party (art 4); that agreed rights of use must be available (art 5); and the arrangements must be exempted from certain effects of insolvency law (art 8). These aspects of the FCD are not affected by the Company Security Regulations. Nor are 'title-transfer collateral arrangements', such as 'repos', to which the FCD also applies.)

The FCD does not define what is meant by 'possession or control', and it does not deal with the priority of security interests over financial collateral or the rights of buyers. The Company Security Regulations provide guidance as to when charges over financial collateral need not be registered. They also set out rules of priority as between competing charges and other forms of security, and as between a security interest and the interest of a person who purchases the financial collateral not knowing of a charge over it.

[2] Directive 2002/47/EC of the European Parliament and Council of 6 June 2002, OJ L 168/43.

[3] SI 2003 No 3226.

PART 5

FINANCIAL COLLATERAL

Effectiveness of charge over investment property or cash in insolvency proceedings

36.—(1) A charge over investment property or cash is not effective against an administrator or liquidator unless, before the commencement of winding-up proceedings—

(a) it is registered,

(b) the charge is a security financial collateral arrangement,

(c) the chargee has control of the collateral,

(d) the charge is in favour of an intermediary under regulation 37,

(e) in the case of a supporting obligation, the charge over the obligation it supports is registered or is under the control of the chargee, or

(f) in the case of any right to the proceeds of collateral arising other than only as a result of the terms of a floating charge, if the charge over the original collateral is registered or under the control of the chargee.

(2) A charge over investment property or cash is subordinate to the interest of a person—

(a) who causes the collateral to be seized in accordance with due process to enforce a judgment, including execution, attachment or garnishment, or

(b) who has obtained a charging order or equitable execution which affects or relates to the collateral,

unless the charge falls within paragraph (1)(a) to (f) at the time that person's interest arises.

(3) "Security financial collateral arrangement" and "winding-up proceedings" have the meanings given in the Financial Collateral Arrangements (No. 2) Regulations 2003(**a**).

(**a**) S.I. 2003/3226.

EXPLANATORY NOTES

Regulation 36 Effectiveness of charges over investment property or cash in insolvency proceedings

Like charges over other forms of collateral, a charge over financial collateral will be effective in the debtor company's insolvency if it is registered. However, as an alternative to registration the chargee may take control of the financial collateral. Not only will taking control render the charge effective in the company's insolvency; it will confer advantages in terms of priority.

The FCAR do not provide a definition of 'possession or control'. The recitals to the Directive indicate that the chargee will not have 'possession or control' if the debtor company remains free to dispose of the collateral free of the charge. It is widely agreed that if the debtor company is no longer free to dispose of the collateral free of the charge (often described as the chargee having 'negative control'), that amounts to 'possession or control' within the FCD. The Law Commission is as confident as it can be that this is the correct test to apply. However it is advised that it cannot rule out the possibility of the European Court of Justice adopting a more liberal interpretation. For example, the ECJ might hold that a party has 'possession or control' if it is in a position to realise the company's investment property at short notice, even though the debtor meanwhile remains free to deal with the collateral. (In English law this would amount to a form of floating charge.) It has therefore proved impossible to provide a definition for the purposes of the Directive without the risk that parties to arrangements that relied on the definition might be deprived of the rights (for example, in insolvency proceedings) that they must be given under the FCD. Conversely, they might receive preferential treatment that is not justifiable under the Directive.

Nonetheless, the Regulations give guidance on when a charge need not be registered. They provide that it need not be registered when either it is a 'security financial collateral arrangement' (that is, the chargee has 'possession or control' and the arrangement is evidenced in writing) within the meaning of the FCD (whatever that means) *or* it has control within the meaning set out in detail in regulation 40. A chargee who obtains control within the terms of regulation 40 can be confident that the charge will not be ineffective in insolvency for want of registration. It is also widely agreed that the chargee who complies with regulation 40 or 41 will have done sufficient to have 'possession or control' within the meaning of the FCAR and thus to gain the various advantages offered by the FCD. It is possible that a party who has merely taken steps that do not meet the tests set out in regulation 40 may also be held to have satisfied the requirements of the FCD. It would then be entitled to the same advantages, including its charge being effective in the debtor's insolvency though not registered. Whether a chargee wishes to take the chance that a more liberal interpretation of the FCD is correct is a matter for its legal and commercial judgement.

The test of 'control' laid down in regulation 40 is also used to determine issues of priority under regulation 39.

Automatic charge in favour of intermediary etc

37.—(1) A fixed charge in favour of an intermediary arises over a person's financial assets held with the intermediary if—

(a) the person buys the financial assets through the intermediary in a transaction in which the person is obliged to pay the purchase price to the intermediary at the time of the purchase, and

(b) the intermediary credits the financial assets to the buyer's securities account before the buyer pays the intermediary.

(2) The charge described in paragraph (1) secures the person's obligation to pay for the financial assets.

(3) A floating charge in favour of a person who delivers a certificated financial instrument or other financial asset represented by a document arises over those financial assets if—

(a) the financial assets are—

(i) in the ordinary course of business transferred by delivery with any necessary endorsement or assignment, and

(ii) delivered under an agreement between persons in the business of dealing with such financial assets, and

(b) the agreement calls for delivery against payment.

(4) The charge described in paragraph (3) secures the obligation to make payment for the financial assets.

Purchaser takes free: investment property

38.—(1) A purchaser of a certificated financial instrument in bearer form who—

(a) gives value, and

(b) obtains possession of the instrument,

without knowing that the purchase constitutes a breach of the terms of a charge which was created or provided for over the instrument, acquires the instrument free of the charge.

(2) A purchaser of a certificated financial instrument in registered form or of an uncertificated financial instrument who—

(a) gives value, and

(b) is registered as the holder of the instrument,

without knowing that the purchase constitutes a breach of the terms of a charge which was created or provided for over the instrument, acquires the instrument free of the charge.

(3) If a person who acquires a financial asset held with an intermediary which is transferred to an account held in that person's name—

(a) gives value, and

(b) at the time of the transfer does not know that the acquisition constitutes a breach of the terms of the charge,

that person acquires the asset free of the charge.

EXPLANATORY NOTES

Regulation 37 Automatic charge in favour of intermediary etc

It may happen that an investor buys indirectly-held financial assets through an intermediary, which credits them to the investor's account before the investor has paid the intermediary. The intermediary will have an automatic fixed charge over the assets. The charge does not require registration to be effective but it will lose priority to a subsequent charge under which the chargee takes control of the collateral (regulation 39). A charge will also arise in favour of a party who delivers certificated financial instruments under an agreement under which payment was due on delivery before the payment has been made, but in this case, since the relevant certificate has been handed over to the debtor, the charge will be only a floating charge.

Regulation 38 Purchaser takes free: investment property

Regulation 38 sets out rules on when purchasers of investment property will take free of a charge over the property. The provisions are designed to ensure that investment property is readily transferable without the need for purchasers to make enquiries. Essentially, purchasers who do not know of the security interest, or know of it but do not know that the disposition to them is in breach of the security agreement, will take free if (before they acquire any relevant knowledge) they take the investment property into their own name. A person does not have knowledge of something for the purposes of the scheme merely because it has been included in a registered financing statement (regulation 19). Thus 'innocent' purchasers who have taken the steps described can be confident that no other charge over the investment property will be effective against them.

Under the regulations, 'purchaser' includes a mortgagee or chargee. This means that a secured creditor may rely on regulation 38 even when it would not obtain priority under regulation 39. Thus if a secured creditor is permitted to have investment property transferred into its name, not knowing that the disposition to it is in breach of a previous charge agreement, it will take free of the charge. This will apply if the previous charge was a floating charge, or if it was a fixed charge which was merely registered instead of the chargee having control of the collateral. It will also apply if the chargee under the previous charge had obtained control but by some accident the collateral was nonetheless transferred into the name of the second secured creditor. This might happen if, for example, an intermediary overlooked a notice of assignment or an agreement with the earlier chargee. The earlier chargee would have a remedy against the intermediary but the second secured party would take free.

Special priority rules for investment property and cash

39.—(1) Subject to regulation 38 (purchaser takes free: investment property), the following provisions govern priority between conflicting charges or pledges over the same investment property or cash.

(2) A charge or pledge under which the chargee or pledgee has control of the investment property or cash has priority over a charge or pledge under which the chargee or pledgee does not have control.

(3) Conflicting charges under which each chargee has control of the investment property or cash rank according to the order in which control was acquired.

(4) Conflicting charges granted by an intermediary under which the chargee does not have control rank equally.

(5) In all other cases, priority among conflicting charges over investment property or cash is governed by regulation 24 (residual priority rules).

(6) Regulation 24(10) and (11) apply to charges and pledges over investment property and cash with the following modifications—

(a) the reference to a registered charge or pledge includes one under the control of the chargee or pledgee, and

(b) the reference to persons mentioned in regulation 20(4) includes persons mentioned in regulation 36(2) (judgment creditors etc).

Meaning of "control"

40.—(1) A chargee or pledgee has control of collateral in the cases set out in paragraphs (2) to (9), but only if—

(a) the charge or pledge, and

(b) the arrangement under which the chargee or pledgee has control of the collateral,

are evidenced in writing or by the recording (by electronic means) of a conversation.

(2) A chargee or pledgee has control of a certificated financial instrument in bearer form if he obtains possession of the certificate and the debtor has not regained possession.

(3) A chargee has control of a certificated financial instrument in registered form if he—

(a) has possession of the certificate, or

(b) is registered with the issuer as the holder.

(4) A chargee has control of an uncertificated financial instrument held in a settlement system if—

(a) the operator of the system, on the instructions of the registered holder, has credited the financial instrument to a sub-account in the holder's own name but the holder has given the chargee a power of attorney over the financial instrument,

(b) the operator of the system is only permitted to effect a transfer of title to the financial instrument on the instructions of the chargee or a person acting on the chargee's behalf and attributable to the debtor,

(c) entry in the register maintained by or on behalf of the operator of the system determines legal title and the chargee is entered in that register as the holder, or

(d) entry in the register maintained by or on behalf of the issuer determines legal title and the chargee is entered in that register as the holder.

(5) A chargee has control of financial assets held with an intermediary—

(a) if the assets are transferred to an account held by the chargee,

EXPLANATORY NOTES

Regulation 39 Special priority rules for investment property and cash

Regulation 39 sets out the rules governing the priority of competing charges and, for the rare cases where it will be relevant, pledges of financial collateral. The basic principles are two. First, a charge perfected by control will take priority over one that it not perfected by control, for example, one that is perfected by registration (and see regulation 37). This means that a chargee who has control may safely advance funds without needing to search to see if a charge over the collateral has been registered. Secondly, as between competing charges each of which is perfected by control, priority depends on the order in which control was obtained. For directly-held securities, it is not possible for more than one secured party to obtain control. Where investment property is held through an intermediary and with cash, it is possible. In each case a potential chargee can make enquiries of the intermediary or 'cash debtor' to find whether any other party already has control.

Any issues not settled by regulation 39 fall to be decided according to the residual rules on priority in regulation 24.

It should be noted that a secured party may also be a protected purchaser within regulation 38. This may result in a mortgagee of investment property taking priority even over an earlier charge that has been perfected by control of another form, such as by notification of the charge to the intermediary.

Regulation 40 Meaning of control

Regulation 40 sets out steps that a chargee (or, in the case of a bearer security, a pledgee) of particular forms of investment property may take to obtain control over various forms of investment property and over 'cash'.

In each case there must be evidence in writing of the agreement and the arrangement under which the collateral was provided, as required by the FCAR. However the requirement is attenuated. It need not be signed and it need only be available by the time the relevant dispute arises. Moreover, in accordance with the accepted interpretation of the FCD (based on the travaux préparatoires) a recording of a telephone or other conversation will suffice (as will an email or other electronic communication using writing, which is generally sufficient in English law to satisfy a requirement of writing).

Paragraph (2) deals with bearer securities, (3) with directly held-certificated registered shares and paragraph (4) with uncertificated securities held in the CREST system.

Paragraphs (5) and (6) deal with financial assets held through an intermediary, and paragraphs (7) and (8) with 'cash'. In the majority of cases the chargee can obtain control by giving notice of its interest to the intermediary or 'cash debtor' ('cash debtor' is defined in regulation 41(1)). If the intermediary or cash debtor is entitled to disregard a notice of assignment, the chargee will need to obtain that person's agreement in order to achieve control.

Regulation 40(9) provides a 'residual test' for cases that do not fall within (2)-(8), for example new situations that might emerge. It is, in broad terms, that the chargee will have control (within the meaning of these Regulations) if it has the 'negative control' described earlier. It too is subject to the requirement of evidence in writing, see above.

(b) where the intermediary is bound or compelled under any enactment, instrument or rule of law to receive notice of an interest in financial assets held with it, if the intermediary has been given notice of the assignment by way of mortgage or of a fixed charge, or

(c) where the intermediary is not so bound or compelled, if the chargee has obtained the intermediary's agreement that the debtor will no longer be able to deal with the collateral without the agreement of the chargee.

(6) If an interest in financial assets held with an intermediary is granted by an account holder to the account holder's own intermediary, the intermediary has control.

(7) If a cash debtor is the chargee of cash it has control of the cash.

(8) Any other chargee with a fixed charge over cash has control of the cash—

(a) where the cash debtor is bound or compelled under any enactment, instrument or rule of law to receive notice of an interest in cash held with it, if the chargee notifies the cash debtor of the fixed charge,

(b) where the cash debtor is not so bound or compelled, if the chargee has obtained the cash debtor's agreement that the debtor will no longer deal with the collateral, or

(c) if, with the agreement of the cash debtor and the debtor, the cash is transferred into the chargee's name.

(9) In a case not falling within any of paragraphs (2) to (8), a chargee or pledgee has control of collateral consisting of investment property or cash if the debtor is no longer able to deal with the collateral.

(10) If a charge extends to after-acquired investment property held in a securities account or cash, control over the after-acquired investment property or cash runs from the time control was first obtained over investment property held in that account or the cash subject to the charge.

(11) Any right of the debtor to substitute equivalent collateral or withdraw excess collateral does not, of itself, prevent investment property or cash being held under the control of the chargee or pledgee.

(12) A chargee who appoints a receiver under a power granted by the charge agreement does not thereby have control.

Meaning of other expressions used in Part 5

41.—(1) In these Regulations—

"account holder" means a person in whose name an intermediary maintains a securities account;

"cash" means money (in any currency) credited to an account, or a similar claim for repayment of money and includes money market deposits and sums due or payable to, or received between, the parties in connection with the operation of a financial collateral arrangement or close-out netting provision (as defined in regulation 3 of the Financial Collateral Arrangements (No. 2) Regulations 2003(**a**));

"cash debtor", in relation to a debtor, means a person who owes cash to the debtor.

"certificated financial instrument" means a financial instrument represented by a certificate;

"deal with", in relation to collateral, means that the debtor is no longer able to dispose of the collateral free of the chargee's or pledgee's interest or so as to give a purchaser an interest ranking in priority to that of the chargee or pledgee;

"financial asset" means—

(a) a financial instrument,

(b) an obligation of a person or a share, participation or other interest in a person or in property or an enterprise of a person—

(**a**) S.I. 2003/3226.

EXPLANATORY NOTES

Regulation 41 Meaning of other expressions used in Part 5

So far as appropriate, the definitions and terms used in relation to financial collateral are the same, or are derived from, those in the FCD, the FCAR and the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary.

The provisions on financial collateral apply to 'investment property' and to 'cash'. Regulation 41 defines 'investment property' as:

(1) 'financial instruments', whether these are securities for which there is a certificate ('certificated financial instruments') in bearer form or registered form, or are uncertificated. The definition of 'financial instruments' is closely modelled on that used in the FCAR, but is limited to directly-held interests; and

(2) any other form of 'financial asset' that is held through an intermediary. This includes rights under commodity futures contracts and options. The account to which to which financial assets may be credited or debited is termed a 'securities account', the person who maintains the account as an 'intermediary' and the person in whose name the intermediary maintains the account as the 'account holder.'

'Cash' has a particular meaning that is found in the FCD and the FCAR. It means not cash in the everyday sense ('money') but sums of money credited to an account (including a bank account), money market deposits and sums due under a close-out netting arrangement.

(i) which is, or is of a type, dealt in or traded on financial markets, or

(ii) which is recognised in any area in which it is issued or dealt in as a medium for investment,

(c) any property which is held by an intermediary for another person in a securities account if the intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under these Regulations, or

(d) a commodity futures contract, a commodity futures option or other similar contract;

"financial instrument" means—

(a) a share in a company or any other financial instrument equivalent to a share in a company,

(b) a bond or other form of financial instrument giving rise to or acknowledging indebtedness which is, or is of a type, dealt in or traded on financial markets, and

(c) any other financial instrument which is normally dealt in and which gives the right to acquire any such share, bond, instrument or other security by subscription, purchase or exchange or which gives rise to a cash settlement (excluding an instrument of payment),

and includes a unit of a collective investment scheme within the meaning of the Financial Services and Markets Act 2000(**a**), an eligible debt security within the meaning of the Uncertificated Securities Regulations 2001(**b**), a money market instrument, an uncertificated unit of an interest in a security as defined in the Uncertificated Securities Regulations 2001, and any rights, privileges or benefits attached to or arising from any of the financial instruments included in this definition;

"intermediary" means a person who maintains registers or accounts to which financial assets may be credited or debited for others, or both for others and for his own account, but does not include—

(a) a person who acts as a registrar or transfer agent for the issuer of financial instruments, or

(b) a person who maintains registers or accounts in the capacity of operator of a system for the holding and transfer of financial instruments on records of the issuer or other records which constitute the primary record of entitlement to financial instruments as against the issuer;

"investment property" means a financial instrument, whether certificated or uncertificated and a financial asset held with an intermediary;

"securities account" means an account maintained by an intermediary to which financial assets may be credited or debited;

"settlement system" means a system for the holding and transfer of financial instruments on records of the issuer or other records which constitute the primary record of entitlement to financial instruments as against the issuer;

"uncertificated financial instrument" means a financial instrument not represented by a certificate.

(2) A reference in these Regulations to a financial asset held with an intermediary means the rights of an account holder resulting from a credit of the financial asset to a securities account.

(**a**) 2000 c. 8.
(**b**) S.I. 2001/3755.

EXPLANATORY NOTES

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PART 6

MISCELLANEOUS AND SUPPLEMENTARY

Interpretation: general

42. In these Regulations—

"business day" means any day which is not—

(a) a Saturday or Sunday,

(b) a bank holiday, or

(c) Christmas Day or Good Friday;

"company" has the meaning given in [the Companies Act 2006];

"crops" means crops, whether matured or otherwise, and whether naturally grown or planted, attached to land by roots or forming part of trees or plants attached to land, but does not include trees;

"document of title" means a document written on paper issued by or addressed to a bailee—

(a) which covers goods in the bailee's possession that are identified or are unascertained portions of an identified mass, and

(b) in which it is stated that the goods identified in it will be delivered to a named person, or to the transferee of that person, or to bearer or to the order of a named person;

"goods" means tangible property including fixtures, crops, trees which have been severed and the unborn offspring of animals, but does not include a document of title, a negotiable instrument, investment property which is represented by a certificate, money or minerals falling within the definition of land under the Land Registration Act 2002(**a**) or the Land Charges Act 1972(**b**);

"Lloyd's deposit" means any funds held on trust pursuant to a Lloyd's deposit trust deed or a Lloyd's security and trust deed;

"Lloyd's relevant trust fund" means any funds held on trust under a trust deed entered into by the member in accordance with the requirements of the Authority and Byelaws of the Society for the payment of an obligation arising in connection with insurance market activity carried on by a member, or for the establishment of a Lloyd's deposit, and includes funds held on further trusts declared by the Society or the trustee of such a trust deed in respect of any class of insurance market activity;

"money" means notes and coins which are legal tender in any currency;

"negotiable instrument" means—

(a) a cheque, bill of exchange or promissory note within the meaning of the Bills of Exchange Act 1882(**c**), or

(b) any other document written on paper which evidences a right to payment of money and is of a type which, in the ordinary course of business, is transferred by delivery with any necessary endorsement or assignment,

but does not include a document of title or investment property;

"pledge" includes a contractual lien;

"purchase" means take by sale, lease, discount, assignment, negotiation, charge, pledge, issue, reissue, gift or any other consensual transaction that creates an interest in property; and "purchaser" has a corresponding meaning;

(**a**) 2002 c. 9.
(**b**) 1972 c. 61.
(**c**) 1882 c. 61.

EXPLANATORY NOTES

PART 6 MISCELLANEOUS AND SUPPLEMENTARY

Regulation 42 Interpretation: General

Regulation 42 provides definitions of a number of terms that are used in the Regulations and which are not defined in the particular regulation in which they appear.

"supporting obligation" means a right to the sums due under of a letter of credit or a guarantee or indemnity which supports the payment or performance of the principal obligation under receivables, a document of title, a negotiable instrument or investment property;

"value" means any consideration which is sufficient to support a simple contract, and includes an antecedent debt or other obligation.

Index of defined terms

43. This table shows the provisions defining or otherwise explaining expressions used in these Regulations.

Expression	*Regulation*
account debtor	44(1)
account holder	41(1)
additional statement	10(1)
advance	24(13)
business day	42
cash	41(1)
cash debtor	41(1)
certificated financial instrument	41(1)
charge	2(3)
chargee	6(5)
collateral	6(5)
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control	40
crops	42
deal with, in relation to collateral	41(1)
debtor	6(5)
document of title	42
financial asset	41(1)
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foreign company	3(1)
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EXPLANATORY NOTES

Regulation 43 Index of defined terms

This index enables a user to find the definition of any of the terms defined in the Regulations.

Rules	5(6)
sale, in relation to a receivable	2(3)
securities account	41(1)
settlement system	41(1)
supporting obligation	42
uncertificated financial instrument	41(1)
unregistered	5(6)
value	42
verification statement	8(1)

Account debtors and cash debtors

44.—(1) A person who owes receivables (an "account debtor") may take a charge over the receivables.

(2) A cash debtor may take a charge over the cash it owes.

Consequential amendments

45.—(1) [*Apply these Regulations to LLPs as they apply to companies by adding a reference to them in the Limited Liability Partnerships Regulations 2001 (S.I 2001/1090) [and the Limited Liability Partnerships (Scotland) Regulations 2001 (S.I. 2001/128.)*]

(2) Section 245 of the Insolvency Act 1986(**a**) (avoidance of certain floating charges created before onset of insolvency) shall be amended as follows.

(3) In subsection (2), for the word "created" substitute "created or registered".

(4) In the opening words of subsection (3), for the word "created" substitute (in both places) "created or registered".

(5) In the opening words of subsection (4), for the word "creates" substitute "creates or registers".

(6) At the end of that section add—

> "(7) In this section, "registered" means registered under the Company Security Regulations 2006"; and "registers" shall be construed accordingly."

(7) *[A number of other consequential amendments (other than cross-references and minor amendments) are identified in the Explanatory Note.]*

Transitional provisions and savings

46.—(1) In this regulation—

"commencement" means the date when these Regulations come into force,

"pre-commencement registered charge" means a charge which was registered under Part 12 of the Companies Act 1985(**b**) (certain charges void if not registered);

"pre-commencement sale of receivables" means a sale of receivables made before commencement which, had it been made after commencement, could have been registered under these Regulations;

"pre-commencement unregistrable charge" means a charge created before commencement which was not registrable under Part 12 of the Companies Act 1985 but which, had it been created after commencement, could have been registered under these Regulations;

"transitional period" means the period beginning with the date of commencement and ending two years later.

(**a**) 1986 c. 45.
(**b**) 1985 c. 6.

EXPLANATORY NOTES

Regulation 44 Account debtors and cash debtors

This regulation is to confirm that a 'charge-back', or similar agreement under which a debtor takes a charge over the sum that it owes to the chargor, may be effective.

Regulation 45 Consequential amendments

This regulation will make a number of amendments to Insolvency Act 1986. [Items (2), (3) and (4) are yet to be drafted.]

(1) Because it will be possible to register a financing statement at any time, section 245 of the Act will be amended to apply not only to floating charges created in the run-up to insolvency but also to those created before the run-up yet only registered during that period.

(2) Under the scheme, a floating charge that is registered before a subsequent fixed charge will have priority over the fixed charge, unless the parties agree otherwise. However, in insolvency preferential creditors and the unsecured creditors' fund have priority over the floating charge but not the fixed charge. (The same issue arises under current law if the fixed chargee takes with notice of a negative pledge clause in the floating charge.) An amendment to the Act will provide that as, against the preferential creditors and the unsecured fund, the floating charge should have priority to the extent of any fixed charges over which it has priority.

(3) In practice, where a person contemplating taking a fixed charge over a company's assets discovers that the company has already granted a floating charge over the same assets, it will normally not go ahead without reaching an agreement with the floating-charge-holder. It will seek to obtain the floating charge-holder's agreement to allow the fixed charge to take priority. (This is frequently done under current law if the person suspects the floating charge may contain a negative pledge clause.) A further amendment to the Act will make it clear that such a subordination agreement, or any other arrangement that a fixed charge should have priority to a floating charge, will result in the fixed charge also having priority over the preferential creditors and the unsecured creditors' fund.

(4) Payments may be made to a secured creditor and the relevant financing statement then discharged, but later the payments may be 'clawed back' by the liquidator under the provisions of the Act. Provision will be made, if necessary, to ensure that the creditor's right to revert to the security is not impaired.

Regulation 46 Transitional provisions and savings

It will not be necessary to re-register charges that were registered before the date of commencement of the new scheme. They will remain effective and retain their priority as against other pre-commencement charges. As against post-commencement interests, they will be treated as having been registered at the moment of commencement, thus normally giving them priority against later interests (other than charges perfected by control).

(2) Rules may make special transitional provision for cases where the process of registration under Part 12 of the Companies Act 1985 was begun but not completed before commencement.

(3) On commencement, a pre-commencement registered charge—

(a) is to be treated as a registered charge,

(b) retains its priority as against other pre-commencement registered charges, pre-commencement unregistrable charges, pledges and interests arising under pre-commencement sales of receivables, and

(c) is subject to the priority rules in these Regulations as against other charges, pledges and interests arising under sales of receivables.

(4) On commencement, a pre-commencement unregistrable charge—

(a) retains its priority as against other pre-commencement registered charges, pre-commencement unregistrable charges, pledges and interests arising under pre-commencement sales of receivables,

(b) has priority as if it had been registered at commencement, and

(c) is subject to the priority rules in these Regulations as against other charges, pledges and interests arising under sales of receivables.

(5) Except for paragraphs (2) to (7), these Regulations do not apply to a pre-commencement sale of receivables until after the end of the transitional period.

(6) During the transitional period, the interest arising under a pre-commencement sale of receivables has priority over any conflicting charge created, or interest arising under a sale of receivables made, after commencement, whether or not registered.

(7) If a pre-commencement sale of receivables is registered before the end of the transitional period, the commencement date is treated as the date of registration.

Date Secretary of State

Equally it will not be necessary to register charges that were created before the commencement but under current law do not require registration. (This is because it would be very difficult and expensive for many chargees to identify all the unregistrable charges they hold.) These will therefore not appear on the register; it is envisaged that the system will carry a warning of this to searchers. They too will remain effective and retain their priority as against other pre-commencement charges; and they will be treated as having been registered at the moment of commencement.

In contrast, by the end of a transitional period of 2 years sales of receivables and arrangements under which receivables may be sold must be covered by a financing statement. (Such agreements will be much easier to identify, since the agreement will normally be 'active', with receivables being transferred and payments made by the receivables financier to the company on a regular basis.)

APPENDIX B
LIST OF CONSULTEES

List of those who responded to C*ompany Security Interests: A Consultative Report* (2004) Consultation Paper No 176

Academics

Dr Joanna Benjamin
Ian Benson
Professor Iwan Davies
Professor Sir Roy Goode
Louise Gullifer
Professor J K Macleod
Professor Harry Sigman
Society of Legal Scholars
Professor Sir Guenter Treitel
Professor Peter Winship
Professor Philip Wood
Professor Jacob Ziegel

Judges

Chancery Division Judges

Organisations

Angel Trains Limited
Association of Business Recovery Professionals ('R3')
Association of Chartered Certified Accountants ('ACCA')
Association for Payment Clearing Services ('APACS')
Bank of England (Legal Unit)
Bank Leumi (UK) plc
Barclays Bank plc
British Bankers' Association ('BBA')
British Vehicle Rental and Leasing Association ('BVRLA')
City of London Law Society Financial Law Committee
City of London Law Society Insolvency Law Committee
Civil Aviation Authority
Commercial Bar Association ('COMBAR')
Commercial Finance Association ('CFA')
Committee of Scottish Clearing Bankers
Confederation of British Industries ('CBI')
CREST
Deutsche Trustee Company Limited
Factors & Discounters Association ('FDA')

Finance & Leasing Association ('FLA')
Financial Markets Law Committee ('FMLC')
GE Capital Aviation Services Limited
HM Land Registry ('HMLR')
HPI Limited
HSBC Bank plc
Inland Revenue ('IR')
Institute of Credit Management ('ICM')
Institute of Trade Mark Attorneys ('ITMA')
International Factors Group ('IF-Group')
International Swaps and Derivatives Association Inc ('ISDA')
International Underwriting Association
Law Society's Company Law Committee
Lloyds TSB Group
London Investment Banking Association ('LIBA')
Mechanical-Copyright Protection Society & Performing Right Society ('MCPS & PRS')
National Pawnbrokers' Association ('NPA')
Patent Office
Prudential Trustee Co Limited
Royal Bank of Scotland plc ('RBS')
The Association of Corporate Trustees ('TACT')

Practitioners

Allen & Overy LLP
Bird & Bird
Michael Brindle QC
Lyndsay Brown
Clifford Chance LLP
CMS Cameron McKenna
DLA LLP
Robert Eddowes (Lloyds TSB Commercial Finance Limited)
Freshfields Bruckhaus Deringer
Roger Hawkins (Berwin Leighton Paisner)
Mr F A G Kay
Linklaters
Lovells
Graham McBain
Norton Rose
Richards Butler
Slaughter & May

List of those who responded to Registration of Security Interests: Company Charges and Property other than Land (2002) Consultation Paper No 164

Academics

Dr Joanna Benjamin
Professor Robert Bradgate (for Sheffield Institute for Commercial Law Studies)
Professor Michael Bridge
Professor David Capper
Professor Ronald Cuming
Dr John de Lacy
Dr Eilis Ferran
Louise Gullifer
Professor Geraint Howells
Professor Eva Lomnicka
Professor John Lowry
Professor JK Macleod
Professor Gerald McCormack
Professor Andrew McKnight
Professor Annina Persson
Dr Jacobien Rutgers
Professor Len Sealy
Society of Legal Scholars
Adrian Walters
Professor Elizabeth Warren
Professor Philip Wood
Professor Sarah Worthington
Professor Jacob Ziegel

Judges

The Right Hon Sir Andrew Morritt V-C

Organisations

Association of Business Recovery Professionals ('ABRP')
Association of International Accountants
Bar Council Law Reform Committee
Barclays Bank plc
British Bankers' Association
Centre for Instalment Credit Law
Chancery Bar Association
City of London Law Society Banking Law Sub-Committee
Civil Aviation Authority
Commercial Bar Association
Committee of Scottish Clearing Bankers

Commonwealth Bank of Australia
Companies House
Consumer Credit Trade Association
CREST
Experian
Factors & Discounters Association
Faculty of Advocates
Finance and Leasing Association
HM Land Registry
HPI Limited
Insolvency Service
Institute of Chartered Secretaries and Administrators ('ICSA')
Institute of Credit Management ('ICM')
International Underwriting Association ('IUA')
Law Reform Advisory Committee for Northern Ireland
Law Society of Scotland
Law Society's Company Law Committee
Lloyd's
Lord Chancellor's Department Civil Law Development Division
Patent Office
Quoted Companies Alliance ('QCA')
Small Business Service
United Nations Commission on International Trade Law secretariat ('UNCITRAL secretariat')

Practitioners

Alan Berg (Watson Farley Williams)
Richard Calnan (Norton Rose)
Clifford Chance LLP
Martin Hughes (White & Case LLP)
Mr F A G Kay
Russell McVeagh
Tite and Lewis
Gary Walker (Wragge & Co.)
Mark Western (White & Case LLP)